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Foreign Tax Credit for Individuals

For use in preparing
1994 Returns

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Important Reminders

Itemized deduction limit. You may have to reduce your itemized deductions if your adjusted gross income is more than \$111,800 (\$55,900 if married filing separately). If this applies, you will need to make an additional computation to determine your foreign tax credit. See *Itemized deduction limit*, under *Rule for Determining Taxable Income from Sources Outside the United States*.

Maximum capital gains tax. If you compute your tax using the Capital Gain Tax Worksheet in the Instructions for Form 1040, you will need to use a special computation to determine your foreign tax credit. For details, see the discussion under *Capital Gains and Losses*.

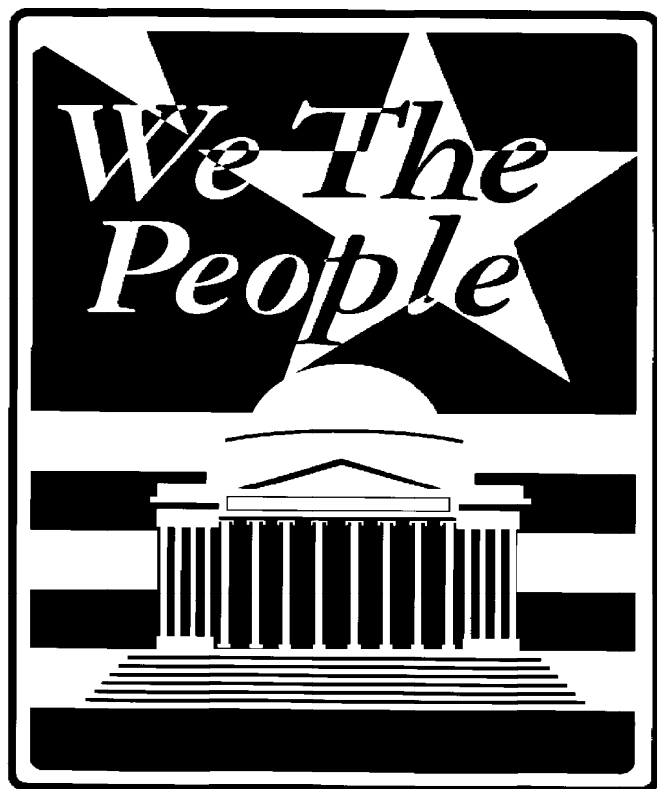
Treaty provisions. You may be required to report certain information with your return if you claim a foreign tax credit under a treaty provision. If you fail to report this information, you may be subject to a penalty of \$1,000. For details, get Publication 519, *U.S. Tax Guide for Aliens*.

If your address changes from the address shown on your last return, use Form 8822, *Change of Address*, to notify the Internal Revenue Service.

Introduction

This publication describes the foreign tax credit that is allowed for income taxes paid to a foreign government on income taxed by both the United States and the foreign country. It also discusses what taxes qualify for the credit and how to figure it. Two examples with filled-in Forms 1116, *Foreign Tax Credit*, are provided at the end of this publication.

If you need information or assistance, and are within the United States, you should call 1-800-TAX-1040 (1-800-829-1040) or the toll-free telephone number for your area listed in



the instructions for the tax forms. If you are located outside the United States, write to:

Internal Revenue Service
Assistant Commissioner (International)
Attn: CP:IN:C:TPS
950 L'Enfant Plaza South, S.W.
Washington, DC 20024

Useful Items

You may want to see:

Publication

- ☐ **54** Tax Guide for U.S. Citizens and Resident Aliens Abroad
- ☐ **519** U.S. Tax Guide for Aliens
- ☐ **570** Tax Guide for Individuals With Income From U.S. Possessions

Form (and Instruction)

- ☐ **1116** Foreign Tax Credit
- ☐ **Schedule D** (Form 1040) Capital Gains and Losses

Ordering publications and forms. To order free publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. If you are located outside the United States contact the nearest U.S. embassy.

Telephone help for hearing-impaired persons. If you are in the United States and have access to TDD equipment, you can call 1-800-829-4059 with your tax questions or to order forms and publications. See your tax package for the hours of operation.

What is the Foreign Tax Credit?

The foreign tax credit is intended to relieve U.S. taxpayers of the double tax burden when their foreign source income is taxed both by the United States and the foreign country from which the income comes. Generally, if the foreign tax rate is higher than the U.S. rate, there will be no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income will be limited to the difference between the rates. However, because the foreign tax credit applies only with respect to foreign source income, it does not affect U.S. taxes attributable to U.S. source income.

Choice To Take Credit or Deduction

You can choose each tax year to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction. You can change your choice for each year's taxes.

To choose the foreign tax credit, you must complete and attach Form 1116, *Foreign Tax Credit*, to your U.S. tax return. To choose the foreign tax deduction, you claim the taxes as an itemized deduction on Schedule A, Form 1040.

Choice Applies to All Qualified Foreign Taxes

If you choose to take a credit for foreign taxes, you generally must take the credit for all qualified foreign taxes. You cannot deduct any of these taxes. Conversely, if you choose to deduct qualified foreign taxes, you must deduct all of them. You cannot take a credit for any of them.

Foreign taxes not allowed as a credit. You can deduct any foreign tax that is not allowed as a credit because of your participation in or cooperation with an international boycott (discussed later under *International Boycott*), even though you claim a credit for other foreign taxes.

You also can deduct, even if you claim a credit for other foreign taxes, foreign income taxes paid to certain countries for which a credit is not allowed because these countries provide support for acts of international terrorism, or the United States does not have diplomatic relations with them or recognize their governments. See the discussion later under *Foreign Taxes for Which You Cannot Take a Credit*.

The deduction for foreign taxes other than foreign income taxes is not related to the foreign tax credit. Certain foreign taxes for which you cannot take the credit, such as real and personal property taxes, may be deductible on your U.S. tax return even though you claim the foreign tax credit for foreign income taxes.

Generally, you can deduct these other taxes **only if** they are expenses incurred in a trade or business or in the production of income. However, you can deduct foreign real property taxes that are not expenses incurred in your trade or business as an itemized deduction on Schedule A (Form 1040).

You can claim the carryback or carryover of unused foreign taxes, only as a credit in the year to which you carry it. Therefore, in any tax year in which you deduct qualified foreign taxes, no carryback or carryover is allowed either as a credit or as a deduction.

Moreover, you must reduce the amount of carryback or carryover that you may carry to another tax year by the amount that you would have used had you chosen to claim a credit rather than a deduction in that year.

In order to receive any benefit from a foreign tax credit **carryback or carryover to a year in which you claimed a foreign tax deduction**, you must change your choice of the deduction to that of a credit for all qualified foreign taxes. The period of time during which you can change that choice is explained next.

Making or Changing Your Choice

You can make or change your choice to claim a deduction or credit at any time during the period **within 10 years** from the due date for filing the return for the tax year for which you make the claim. You make or change your choice on your tax return (or on an amended return) for the year your choice is to be effective.

Example. You have paid foreign taxes for the last 13 years and have chosen to deduct them on your U.S. income tax returns. You have been timely in both filing and paying your U.S. tax liability. In February 1994 you file an amended return for tax year 1983 choosing to take a credit for your 1983 foreign taxes because you now realize that the credit is more advantageous than the deduction for that year. Because your return for 1983 was not due until April 16, 1984 (April 15 fell on a Sunday), this choice is timely and you are able to take a credit for the 1983 foreign taxes against your 1983 U.S. tax liability.

After taking a credit for your 1983 foreign tax, you have excess unused foreign 1983 taxes. Ordinarily, you can carry back excess unused foreign taxes to the 2 preceding tax years, and if any unused foreign taxes still remain, you can carry them forward to the following 5 years.

Because you originally did not choose to take a credit for your foreign taxes and the time (10 years) for changing the choice for 1981 and 1982 has passed, you cannot carry the excess unused foreign 1983 taxes back as credits against your U.S. income tax for tax years 1981 and 1982.

However, because 10 years have not passed since the due date for your 1984 through 1988 income tax returns, you can still choose to carry **forward** any unused foreign 1983 taxes. You must reduce the unused 1983 foreign taxes that you carry forward by the amount that would have been allowed as a carryback if you had timely carried back the foreign tax to tax years 1981 and 1982.

Why Choose the Credit

Although no one rule covers all situations, it is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is so because:

- 1) A credit reduces your actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only your income subject to tax.
- 2) You can choose to take the foreign tax credit even if you do not itemize your deductions. You then are allowed the standard deduction in addition to the credit.
- 3) If you choose to take a credit for the foreign taxes paid, and the taxes paid exceed the credit limit for the tax year, you can carry over or carry back the excess to another tax year. (See *Limit on the Credit*, discussed later.)

Example 1. For 1994, you and your spouse have adjusted gross income of \$50,000, including \$20,000 of dividend income

from foreign sources. You file a joint return and have no dependents. You had to pay \$2,000 in foreign income taxes on the dividend income received from sources within a foreign country. If your itemized deductions are otherwise \$6,700, your added deduction for the foreign income tax will reduce your U.S. tax by \$355. If, however, you choose to claim a credit for the \$2,000 foreign tax, your U.S. tax will be reduced by the full \$2,000. Therefore, you have an additional tax benefit of \$1,645 (\$2,000–\$355) by taking the credit.

Example 2. In 1994 you receive investment income of \$5,000 from a foreign country, which imposes a tax of \$3,500 on that income. You report on your U.S. return this income as well as \$34,000 of income from U.S. sources. Assume that you are single, entitled to one exemption, and have other itemized deductions of \$4,400 (\$800 allocable to your foreign income and \$3,600 to U.S. income). If you deduct the foreign tax on your U.S. return, your overall tax bill is \$5,072. If you credit this foreign tax (you can take a credit of only \$726 because of limits discussed later), your net tax liability is \$5,326 which is \$254 more than if you deduct the foreign tax.

Foreign taxes allocable to excluded income. You cannot deduct or take a credit for foreign taxes paid on income excluded under the foreign earned income exclusion or the foreign housing exclusion. The exclusions apply to the tax year for which made and all subsequent years unless you revoke the exclusion election. If you choose to claim the foreign tax credit on income that is eligible for the exclusion, you will be considered to have revoked the exclusion election. You will not be able to claim these exclusions for the next 5 tax years unless you get IRS approval.

Example. You are a U.S. citizen and meet the qualifications to exclude foreign earned income. You received wages earned in Country X of \$55,000, and paid income tax on these wages to Country X of \$8,200. You also received dividends from Country X sources of \$2,000 and paid income tax on these dividends to Country X of \$300. You can claim a deduction or credit for the \$300 tax payment because the dividends are subject to U.S. tax. If you exclude the wages under the foreign earned income or housing exclusion, you cannot claim a deduction or a credit for the foreign income tax of \$8,200 paid on the wages.

Partial exclusion. If you exclude only a part of your wages, see *Taxes on excluded income*, discussed later, under *Reduction in Total Foreign Taxes Available for Credit*.

For information on these exclusions, get Publication 54.

Credit for Taxes Paid or Accrued

A qualified foreign tax can be credited in the tax year in which it is paid or in the tax year in which it is accrued. The tax year referred to is the U.S. tax year for which your U.S. return is filed.

If you use an accrual method of accounting, you can claim the credit only in the year the tax is accrued.

If you use the cash method of accounting, you can choose to take the credit either in the year the tax is paid or in the year it is accrued. See *Choosing to Accrue Taxes*, later.

Cash method. If you report all items of income in the year you actually or constructively receive them, and deduct all expenses in the year you pay them, you are using the cash method of accounting.

Accrual method. You are using an accrual method of accounting if you report income when you earn it, whether or not you receive it, and you deduct your expenses when you incur them, rather than when you pay them.

Foreign Tax Accrual

Foreign taxes generally accrue when all the events have taken place that fix the amount of the tax and your liability to pay it. However, even if you are contesting the liability, you can claim the credit for taxes accrued (to the extent the contested tax is paid). If your claim with the foreign country is accepted, you must make an adjustment in the credit, as discussed below.

You may be required to post a bond. If you claim a credit for taxes accrued but not paid, you may have to post an **income tax bond** to guarantee your payment of any tax due on any redetermination of the foreign tax liability.

This bond can be requested at any time without regard to any period of limitations.

Adjustments. You must make an adjustment if you later find that the amount of accrued foreign taxes for which you took a credit is different from the amount of qualified foreign taxes that you paid. This may occur if you accrue and credit foreign taxes in one year and later find that you must pay additional foreign taxes for that year. It also may occur if you later find that the taxes credited were too much, and you receive a foreign tax refund.

Currency fluctuation. You must also make an adjustment to the taxes accrued if you find that they differ from the amount paid because of fluctuations in the value of the foreign currency between the date of accrual and the date of payment.

In any case, **the foreign tax you can take as a credit** is the amount you actually paid to the foreign country. The time of the credit remains the year of accrual.

Notice to the Internal Revenue Service of change in tax. You must file Form 1040X, *Amended U.S. Individual Income Tax Return*, and Form 1116 if you:

- 1) Must pay additional foreign taxes,
- 2) Receive a foreign tax refund, or
- 3) Have a change to the foreign tax accrued because of exchange fluctuations.

The IRS will redetermine your U.S. tax liability for the year or years affected.

A redetermination of your U.S. tax is not required if the change is due solely to a foreign currency fluctuation and the foreign tax change for the tax year is less than the **smaller** of:

- 1) \$10,000, or
- 2) 2% of the total dollar amount of the foreign tax initially accrued for that foreign country.

In this case, you must adjust your U.S. tax in the tax year during which the foreign tax is redetermined.

Failure-to-notify penalty. If you fail to notify the Service of a foreign tax change and cannot show reasonable cause for the failure, you may have to pay a penalty.

For each month, or part of a month, that the failure continues, you pay a penalty of 5% of the tax due resulting from a redetermination of your U.S. tax. This penalty cannot be more than 25% of the tax due.

Special limitations period for refund claims. A period of 10 years is allowed for filing a claim for refund of U.S. tax when you must pay a larger foreign tax than you claimed a credit for when the tax accrued. Begin counting the 10 years from the regular due date for filing the return for the tax year for which you make the claim.

Regardless of whether you claim the foreign tax credit on the basis of when the taxes are paid or accrued, the same limitation period applies to claims for refund or credit based on:

- 1) The correction of mathematical errors in figuring creditable foreign taxes,
- 2) The discovery of creditable taxes in addition to those reported on the return, or
- 3) Any other adjustment to the size of the credit. An adjustment to the size of the foreign tax credit includes the correction of an error in figuring the foreign tax credit limit.

The special 10-year limitation period also applies to making or changing your choice of whether to claim a deduction or credit for foreign taxes. See *Making or Changing Your Choice*, discussed earlier under *Choice To Take Credit or Deduction*.

Foreign tax refund. If you receive a foreign tax refund without interest from the foreign government, **you will not have to pay interest** on the amount of tax due resulting from the adjustment to your U.S. tax for the time before the date of the refund.

However, if you receive a foreign tax refund with interest, **you must pay interest** to the Internal Revenue Service up to the amount of the interest paid to you by the foreign government. The interest you must pay cannot be more than the appropriate rate of interest on the tax due the United States resulting from the adjustments.

Example. In 1991, you paid foreign taxes of \$1,000 to Country A. In 1994, you received a refund of \$300 of these taxes, with interest of \$35. You must make an adjustment of \$300 on your 1991 U.S. return. If you owe additional tax

because of this adjustment, you will have to pay interest (up to \$35) on the deficiency for the time before the date of the refund. However, you will not pay more interest than the appropriate U.S. rate of interest on the tax due.

Foreign tax imposed on foreign refund. If you receive a foreign tax refund that is taxed by the foreign country, you cannot take a separate credit or deduction for this additional foreign tax. However, when you refigure the credit taken for the original tax, reduce the refund by the foreign tax paid on it.

Example. You paid a foreign income tax of \$3,000 in 1992, and received a foreign tax refund of \$500 in 1994 on which a foreign tax of \$100 was imposed. Because you can reduce your refund by the foreign tax imposed on it, you must make an adjustment of only \$400 to the credit you took against your 1992 U.S. income tax.

Choosing to Accrue Taxes

You must choose to accrue foreign taxes if you use the cash method and want to take a credit for foreign taxes in the year they accrue. You make the choice by checking the box in Part II of Form 1116. Once you make that choice, you must follow it in all later years and take a credit for foreign taxes in the year they accrue.

In addition, the choice to accrue creditable foreign taxes applies to *all* foreign taxes qualified for credit. Thus, you cannot take a credit for some foreign taxes when paid and take a credit for others when accrued.

If you make this choice, you cannot claim a deduction for accrued taxes.

You may have a credit for taxes attributable to more than one year in the year in which you choose to take a credit for foreign taxes on an accrual method if you previously used the cash method.

Example. You have been using the cash method, and for your 1994 tax year chose to use an accrual method of crediting foreign taxes. During 1994 you paid foreign income taxes owed for 1993. In addition, in 1994 you accrued foreign income taxes that you had not paid by the close of your 1994 tax year. You are entitled to a credit on your return for 1994 that includes both your foreign income taxes paid and those accrued during that year.

Who Can Take the Credit?

If you have paid foreign income tax and are subject to U.S. tax on foreign source income, you may be able to take a foreign tax credit.

U.S. Citizens

If you are a U.S. citizen, you are taxed by the United States on your worldwide income wherever you reside. You are normally entitled to take a credit for foreign taxes you pay or accrue with respect to foreign source income.

If you are a citizen of a U.S. possession (except Puerto Rico), not otherwise a citizen of the United States, and are not a resident of the United States, you cannot take a foreign tax credit.

Excluded income. You cannot take a credit for foreign income taxes you pay or accrue on income that you exclude from gross income under the foreign earned income or foreign housing exclusion. See the discussion of *Taxes on excluded income*, later, under *Reduction in Total Foreign Taxes Available for Credit*. These exclusions are discussed in detail in Publication 54.

If you are a bona fide resident of American Samoa and exclude income from sources in American Samoa, Guam, or the Northern Mariana Islands, you cannot take a credit for the taxes attributable to the excluded income. For more information on this exclusion, see Publication 570.

Resident Aliens

If you are a resident alien of the United States, you can take a credit for foreign taxes subject to the same general rules as U.S. citizens. If you are a bona fide resident of Puerto Rico for the entire tax year, you also come under the same rules.

Usually, you can take a credit *only* for those foreign taxes imposed on your foreign source income. You must have actually or constructively received the income while you had resident alien status.

If you qualify for the foreign earned income exclusion and exclude income, you cannot take a foreign tax credit for foreign income taxes paid or accrued on the excluded income. See the discussion of *Taxes on excluded income*, later, under *Reduction in Total Foreign Taxes Available for Credit*. For information on alien status, see Publication 519.

Nonresident Aliens

As a nonresident alien, you can claim a credit for taxes paid or accrued to a foreign country or possession of the United States *only* on foreign source or possession source income that is effectively connected with a trade or business in the United States. For information on alien status and effectively connected income, see Publication 519.

Who Paid or Accrued the Foreign Tax?

Generally, you can claim the credit *only if* you paid or accrued the foreign tax. However, in some instances you can claim the credit even if you did not directly pay or accrue the tax yourself.

Joint return. If you file a joint return, you can credit the total of any foreign income tax paid or accrued by you and your spouse.

Partner or S corporation shareholder. If you are a member of a partnership, or a shareholder in an S corporation, you can credit your

proportionate share of the foreign income taxes paid or accrued by the partnership or the S corporation. However, if you are a shareholder in an S corporation that in turn owns stock in a foreign corporation, you cannot claim a credit for your share of foreign taxes paid by the foreign corporation.

Beneficiary. If you are a beneficiary of an estate or trust, you may be able to credit your proportionate share of foreign income taxes paid or accrued by the estate or trust. However, to do so, you must show that the tax was imposed on income of the estate and not on income received by the decedent.

Investment company shareholder. If you are a shareholder of a regulated investment company (mutual fund) or a foreign investment company, you may be able to credit your share of foreign income taxes paid by the company if it chooses to pass the credit on to its shareholders. You should receive from the mutual fund a Form 1099-DIV, or similar statement, showing the foreign country or U.S. possession, your share of the income from that country, and your share of the foreign taxes paid to that country. If you do not receive this information you will need to contact the company.

Controlled foreign corporation shareholder. If you are at least a 10% shareholder of a controlled foreign corporation and choose to be taxed at corporate rates on the amount you must include in gross income from that corporation, you can credit your share of foreign taxes paid or accrued by the controlled foreign corporation.

French corporation shareholders. If you receive dividends from a French corporation, you should apply the following rules to figure what amount of French tax paid on these dividends is available for credit.

Under the tax treaty with France, *dividends* received by a U.S. shareholder from a French corporation are subject to a 15% withholding tax. The U.S. shareholder is considered to have paid one-half of the French corporate income tax on the dividend. That tax "payment" will be refunded to the U.S. shareholder provided a timely claim for refund is filed.

The refund of the French corporate tax is considered a distribution by the paying French corporation. Therefore, the refund plus the withholding tax on it is included in the U.S. shareholder's gross income in the year received.

Example. You are a shareholder in a French corporation that paid you a dividend of \$1,000 (\$850 net plus \$150 tax withheld). The dividends paid out by the corporation amounted to 50% of its before-tax profits for the year. Since, under the French tax system, the corporate tax is assessed at the rate of 50% of profits, one-half of the tax allocable to the dividend would be \$500 ($\frac{1}{2}$ of \$1,000). This amount (\$500) is considered to have been paid by you and will be refunded to you by the French Government if you file a timely claim for refund. Assuming that you receive your

French tax refund in the same tax year you receive the dividend, your U.S. gross income includes \$1,500 French source dividends (\$1,000 + \$500). Your tax paid to France would be \$225 (\$150 withheld from the dividend plus \$75 withheld from the tax refund).

How to obtain refund of French tax. The original and two copies of French Form RF-1A EU (No. 5052), *Application for Refund*, are to be completed, dated, and signed by the U.S. shareholder and certified by the U.S. financial institution through which the dividend proceeds were paid. The original and copies must then be transmitted to the French paying establishment. If the U.S. financial institution refuses to certify the form, the original and three copies can be sent to:

IRS—Philadelphia Service Center
Foreign Certification Request
P. O. Box 16347
Philadelphia, PA 19114-0447

Get Publication 686, *Certification for Reduced Tax Rates in Tax Treaty Countries*, for more information.

The U.S. shareholder must submit the forms for processing in enough time for the completed forms to reach the French paying establishment before the end of the year in which the dividends were received. If unusual circumstances make this impossible, the forms must reach the paying establishment in time for it to file the forms with the French tax administration no later than December 31 of the year following the year in which the dividends were received by the U.S. shareholder.

You can get Form RF-1A EU (No. 5052) by writing to:

Internal Revenue Service
Assistant Commissioner (International)
ATTN: CP:IN:C:TPS
950 L'Enfant Plaza South, S.W.
Washington, DC 20024

What Foreign Taxes Qualify for the Credit?

Generally, only income, war profits, and excess profits taxes (income taxes) paid or accrued during the tax year to a foreign country (defined later) or a U.S. possession qualify for the foreign tax credit. However, under certain conditions a tax paid or accrued to a foreign country or U.S. possession in lieu of a tax on income, war profits, or excess profits will qualify. (See *Taxes in Lieu of Income Taxes*, later.)

As a general rule, **to qualify for the credit**, the foreign tax must have been imposed on you and you must have paid or accrued the foreign tax. You cannot shift the right to claim the credit by contract or other means unless specifically provided by law. A qualified tax that is deducted from wages is considered to be imposed upon the recipient of the wages.

The amount of qualified foreign tax that you can use each year for credit purposes or as a deduction is not necessarily the amount of tax withheld by the foreign country. **The amount**

of qualified foreign tax, for credit or deduction purposes, is only the amount of foreign income tax that is the legal and actual tax liability that you paid or accrued during the year.

You cannot take a foreign tax credit or deduction for income taxes paid to a foreign country to the extent it is reasonably certain the amount would be refunded, credited, rebated, abated, or forgiven if you made a claim.

For example, the United States has tax treaties or conventions with many countries allowing U.S. citizens and residents reductions in the rates of tax of those foreign countries. However, some treaty countries require U.S. citizens and residents to pay the tax figured without regard to the lower treaty rates and then claim a refund for the amount by which the tax actually paid is more than the amount of tax figured using the lower treaty rate. For credit or deduction purposes, the taxpayer's qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, since the taxpayer can claim a refund for the excess tax paid.

If a foreign country returns your foreign tax payments to you in the form of a subsidy, you cannot claim these payments as taxes qualified for the foreign tax credit. A subsidy can be provided by any means but must be determined, directly or indirectly, in relation to the amount of tax, or to the base used to figure the tax.

Some ways of providing a subsidy are refunds, credits, deductions, payments or discharges of obligations. The credit is also not allowed if the subsidy is given to a person related to you, or persons who participated in a transaction, or a related transaction, with you.

Foreign country. A foreign country includes any foreign state or political subdivision thereof. Thus, income, war profits, and excess profits taxes paid or accrued to a foreign city or province qualify for the U.S. foreign tax credit.

A foreign country also includes **the continental shelf** of a foreign country if the country has exclusive rights under international law over the exploration and exploitation of natural resources there, and exercises taxing jurisdiction over such exploration and exploitation. This rule for continental shelf areas is limited to services with respect to natural resources.

U.S. possessions. For foreign tax credit purposes, all qualified taxes paid to possessions of the United States are considered foreign taxes. For this purpose, U.S. possessions include Puerto Rico, Guam, the Northern Mariana Islands, and American Samoa.

When the term "foreign country" is used in this publication, it includes U.S. possessions unless otherwise stated.

Foreign Charge Must Be a Tax

Whether an amount imposed by a foreign country (foreign charge or levy) qualifies for credit depends on the characteristics of the charge involved.

Penalties and interest. Amounts paid to a foreign government to satisfy a liability for interest, fines, penalties, or any similar obligation are not taxes and do not qualify for credit.

Tax Must Be Based on Income

To qualify for credit, the foreign levy must be an income tax (or a tax in lieu of income tax). Simply because the levy is called an income tax by the foreign taxing authority does not make it an income tax for this purpose.

To determine whether a foreign levy is an income tax, it must be compared to the U.S. income tax. Therefore, a foreign levy is an income tax only if:

- 1) It is a tax; that is, it is **not** payment for a specific economic benefit (discussed below), and
- 2) The predominant character of the tax is that of an income tax in the U.S. sense.

A foreign levy may meet these requirements even if the foreign tax law differs from U.S. tax law. The foreign law may include in income items that the United States does not include, or it may allow certain exclusions or deductions that are not allowed under the U.S. income tax law.

Payment for a specific economic benefit. Generally, a foreign tax is payment for a specific economic benefit if you receive, or are considered to receive, an economic benefit from the foreign country imposing the tax, **and**

- 1) If there is a generally imposed income tax, the economic benefit is not available on substantially the same terms to all persons subject to the income tax, or
- 2) If there is no generally imposed income tax, the economic benefit is not made available on substantially the same terms to the population of the foreign country in general.

However, see the exception discussed later under *Pension, unemployment, and disability fund payments*.

Economic benefits include: goods; services; fees or other payments; rights to use, acquire or extract resources, patents, or other property that the foreign country owns or controls; and discharges of contractual obligations. Economic benefits do not include the right or privilege merely to engage in business.

You are considered to receive an economic benefit if you have a business transaction with a person who receives a specific economic benefit from the foreign country and under the terms and conditions of the transaction, you receive directly or indirectly some part of the benefit.

Dual-capacity taxpayers. If you are subject to a foreign country's levy and you also receive a specific economic benefit from that foreign country, you are a "dual-capacity taxpayer." As a dual-capacity taxpayer, **you cannot claim a credit for any part of the foreign levy, unless** you establish that the

\$64,354	(\$77,225 — \$12,871)
\$100,000	(\$120,000 — \$20,000)

amount paid under a distinct element of the foreign levy is a tax, rather than a compulsory payment for a direct or indirect specific economic benefit.

For more information on how to establish amounts paid under separate elements of a levy, write to the Internal Revenue Service, Assistant Commissioner (International), Attention: CP:IN:C:TPS, 950 L'Enfant Plaza South, S.W., Washington, D.C. 20024.

Pension, unemployment, and disability fund payments. A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for similar purposes, is not payment for a specific economic benefit if the amount of the tax does not depend on the age, life expectancy, or similar characteristics of that individual.

Social security taxes. No deduction or credit is allowed, however, for social security taxes paid or accrued to a foreign country with which the United States has a social security agreement. For more information about these agreements, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, or Publication 519, *U.S. Tax Guide for Aliens*.

Soak-up taxes. A foreign tax, to the extent it is a soak-up tax, does not qualify for credit because it is not predominantly an income tax. It is a soak-up tax to the extent that liability for it depends on the availability of a credit for it against income tax imposed by another country. This rule applies only if and to the extent that the foreign tax would not be imposed but for the availability of such a credit.

Taxes based on income. Foreign taxes on wages, dividends, interest, and royalties generally qualify for the credit. Furthermore, foreign taxes on income can qualify even though they are not imposed under an income tax law.

Taxes not based on income. Foreign taxes based on gross receipts, rather than on realized net income, do not qualify *unless* they are imposed in lieu of an income tax, as discussed next. Taxes based on assets, such as property taxes, do not qualify for the credit.

Taxes in Lieu of Income Taxes

A tax paid or accrued to a foreign country qualifies for the credit if it is imposed in lieu of an income tax otherwise generally imposed. A foreign levy is a tax in lieu of an income tax only if:

- 1) The tax is not payment for a specific economic benefit as discussed earlier, and
- 2) It meets the substitution requirements; that is, the tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed. See also the earlier discussion of soak-up taxes.

Since a tax in lieu of an income tax does not have to be based on realized net income, a foreign tax imposed on gross income, gross receipts or sales, or the number of units produced or exported can qualify for the credit.

Reduction in Total Foreign Taxes Available for Credit

You must reduce your total foreign taxes that are available for credit under the following circumstances.

Taxes on excluded income. You must reduce your foreign taxes available for credit or deduction by the taxes paid or accrued on income that is excluded from income under the foreign earned income exclusion or the foreign housing exclusion. See Publication 54 for more information on the foreign earned income and housing exclusions.

If your wages are completely excluded, you cannot deduct any of the foreign taxes paid or accrued on these wages or take a credit for them against the U.S. tax on otherwise taxable income from foreign sources.

If only part of your wages are excluded, you cannot deduct or take a credit for the foreign income taxes allocable to the excluded part. You find the amount allocable to your excluded wages by multiplying the foreign tax paid or accrued on foreign earned income received or accrued during the tax year by a *fraction*.

The numerator of the fraction is your excluded foreign earned income for the tax year minus otherwise deductible expenses directly related and properly apportioned to that income (not including the foreign housing deduction).

The denominator is your total foreign earned income received or accrued during the tax year minus all deductible expenses allocable to that income (including the foreign housing deduction). If the foreign law taxes foreign earned income and some other income (for example, earned income from U.S. sources or a type of income not subject to U.S. tax), and the taxes on the other income cannot be segregated, the denominator of the fraction is the total amount of income subject to the foreign tax minus deductible expenses allocable to that income.

Example. You are a U.S. citizen and a cash basis taxpayer, employed by Company X. In 1994, you lived in Country A and qualified for the foreign earned income exclusion. You earned and received \$120,000 of foreign earned income and paid \$20,000 in unreimbursed business travel expenses in 1994. You also paid \$30,000 in income tax to Country A. Your exclusions of foreign earned income and housing allowance total \$77,225.

The amount of the business expenses that is allocable to excluded amounts, and not deductible, is \$12,871. This is figured by multiplying the otherwise allowable deductions by a fraction that is your excluded amounts over your foreign earned income (\$20,000 × \$77,225/\$120,000).

The amount of Country A tax that is allocable to excluded amounts and, therefore, not creditable or deductible, is \$19,306. This is figured by multiplying the tax of \$30,000 by the following fraction:

Taxes on foreign mineral income. You must reduce any taxes paid or accrued to a foreign country or possession on mineral income derived in the country or possession if you were allowed a deduction for percentage depletion for any part of the mineral income.

Taxes specifically attributable to international boycott operations. In general, if you participate in or cooperate with an international boycott, your foreign taxes attributable to the boycott activity will reduce the total taxes available for credit. For more information, see the discussion later under *International Boycott*.

Taxes of persons controlling foreign corporations. If you control a foreign corporation, you must file an annual information return on **Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations**.

If you fail to file the return by the due date, you must reduce by 10% all foreign taxes that may be used for the foreign tax credit. You then subtract from this 10% reduction any dollar penalty for failure to furnish this information. Generally, the dollar penalty is \$1,000 for each failure. You must also make reductions of 5% for each additional 3-month period, or part of a period if the failure continues for 90 days or more.

Foreign Taxes for Which You Cannot Take a Credit

You cannot claim a foreign tax credit for taxes paid or accrued to any country if the income giving rise to the tax is attributable to a period (the sanction period) during which:

- 1) The country has been designated by the Secretary of State as a country that repeatedly provides support for acts of international terrorism,
- 2) The United States has severed or does not conduct diplomatic relations with the country, or
- 3) The United States does not recognize a country's government, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act.

The following countries meet the above description for 1994:

Table 1. Countries That Do Not Qualify for a Foreign Tax Credit in 1994

Afghanistan	Libya
Cambodia	North Korea
Cuba	Syria
Iran	Vietnam
Iraq	

Income that is paid through one or more entities is treated as coming from a foreign country listed above if, in the absence of the entities, this income would be considered as coming from one of these countries.

Limit on credit. In figuring the foreign tax credit, discussed later, do not include in your total foreign income any income for the sanction period of the countries listed above. This will prevent the foreign taxes for the sanction period of these countries from being used as a credit against the U.S. tax.

Example. During 1994, you lived and worked in Libya until August, when you were transferred to Italy. You earned \$85,000 in Libya through July, and \$40,000 in Italy through the end of the year. You paid taxes to each country on the income earned there. You cannot claim a foreign tax credit for the foreign taxes paid on the income earned in Libya. Therefore, you cannot include the income earned in Libya in total foreign income when you figure your foreign tax credit for the taxes paid to Italy.

Treatment of foreign taxes not allowed as a credit. You cannot carry back or carry forward to other tax years the amount of foreign taxes that you cannot claim as a credit. However, you can deduct any amount that you cannot take as a foreign tax credit. See *Choice to Take Credit or Deduction*, earlier.

Figuring the credit when a sanction ends. Table 2 lists the countries for which sanctions have been lifted. For any of these countries, you can claim a foreign tax credit for the taxes paid or accrued to that country on the income for the period that begins after the end of the sanctioned period.

Example. The sanctions against Country X were lifted on July 31, 1994. On August 19, 1994, you receive a distribution from a mutual fund of Country X income. The fund paid Country X income tax for you on the distribution. Because the distribution was made after the sanction was lifted, you may use the distribution to compute your foreign tax credit.

Income for the non-sanctioned period not determinable. If your tax year includes income from a foreign country for which a sanction period ends in that year and you are not able to determine the income for the non-sanctioned period, you can allocate your income to that period by using the following formula.

$$\frac{\text{Number of nonsanctioned days in year}}{\text{Number of days in year}} \times \frac{\text{Foreign Country's Income for year}}{\text{Foreign Country's Income for nonsanctioned period}} =$$

Example. You are a calendar year filer and received \$20,000 of income from Country X in 1994. Sanctions against Country X were lifted on July 11, 1994. You are unable to determine how much of the income is for the non-sanctioned period. You may use the above formula to determine the amount of the income from the non-sanctioned period. Because your tax year starts on January 1, and the Country X sanction was lifted on July 11,

Table 2. Countries Removed From the Sanctioned List

Country	Sanction Period	
	Starting Date	Ending Date
Albania	January 1, 1987	March 15, 1991
Angola	January 1, 1987	June 18, 1993
South Africa	January 1, 1988	July 10, 1991
People's Democratic Republic of Yemen	January 1, 1987	May 22, 1990

1994, 173 days of your tax year are in the non-sanctioned period. You would compute the income of the non-sanctioned period as follows:

$$\frac{173 \text{ days}}{365 \text{ days}} \times \$20,000 = \$9,589$$

To figure your foreign tax credit, you would use \$9,589 as the income from Country X.

Further information. The rules for figuring the foreign tax credit after a country's sanction period ends are more fully explained in Revenue Ruling 92-62, 1992-2 Cumulative Bulletin, page 193. This ruling can be found in many libraries and IRS offices.

How To Figure the Credit

As already indicated, you can claim a foreign tax credit only for foreign taxes on income, war profits, or excess profits, or taxes in lieu of those taxes. In addition, there is a limit on the amount of the credit that you can claim. You figure this limit and your credit on Form 1116. Your credit is the amount of foreign tax you paid or accrued or the limit, whichever is smaller.

If you have foreign taxes available for credit but you cannot use them because of the limit, you may be able to carry them back to the 2 previous tax years and forward to the next 5 tax years.

Also, certain tax treaties have special rules that you must consider when figuring your foreign tax credit. See *Tax Treaties*, later.

Limit on the Credit

The foreign tax credit is limited to the same proportion of your total U.S. tax that your taxable income from sources outside the United States bears to your total taxable income. See the formula for this below.

To determine this limit, you must separate your foreign source income into categories, as discussed under *Separate Limit Income*. The limit treats all foreign income in each separate category of income as a single unit and limits the credit to the U.S. income tax attributable to the taxable income in that category from all sources outside the United States.

Under the limit in each category, operating losses in one foreign country will offset income from another foreign country.

In determining your taxable income from sources outside the United States, do not include any income from the countries listed

under *Foreign Taxes for Which You Cannot Take a Credit*, discussed earlier.

Figure the limit using the following formula:

$$\frac{\text{Taxable income from sources outside U.S. in category (not in excess of total taxable income)}}{\text{Total taxable income from all domestic and foreign sources}} \times \frac{\text{U.S. income tax}}{\text{Maximum Credit}} =$$

If, in a tax year, none of your foreign income was subject to U.S. tax, the numerator of this fraction would be zero and you would have no foreign tax credit in that year.

If you compute your tax for 1994 using the Capital Gain Tax Worksheet in the Instructions for Form 1040, you need to adjust the denominator. If you had a foreign source capital gain or loss, you also need to adjust the numerator. See *Capital Gains and Losses*, later.

Separate Limit Income

You must figure the limit on a separate basis with regard to each of the following categories of income:

- 1) Passive income,
- 2) High withholding tax interest,
- 3) Financial services income,
- 4) Shipping income,
- 5) Certain dividends from a domestic international sales corporation (DISC) or former DISC,
- 6) Certain distributions from a foreign sales corporation (FSC) or former FSC attributable to foreign trade income,
- 7) Any lump-sum distributions from employer benefit plans for which the special averaging treatment is used to determine your tax, and
- 8) All other income not included in the above categories (**general limitation income**).

Figuring the Separate Limits

In figuring your separate limits, you must combine the income (losses) in each category from all foreign sources, and then apply the limit. **The separate limit is mandatory.**

Example. For 1994 you are single, under 65, do not itemize deductions, and have taxable income of \$30,000 that includes interest income of \$500 from Country X and \$1,500 from Country Y. It also includes \$2,000 of dividends from foreign sources attributable to the

foreign trade income of a FSC and \$10,000 of taxable wages from Country Z. The balance of your taxable income (\$16,000) is from U.S. sources.

These taxable income amounts are for purposes of figuring the limit on the foreign tax credit; that is, **they are gross income amounts after subtracting an allocable part of your standard deduction, but without subtracting your personal exemption.** Your U.S. tax liability before the foreign tax credit is \$4,764, and you figure your limit on foreign taxes as follows:

Separate limit, general limitation income (Country Z)

$$\frac{\$10,000}{\$30,000} \times 4,764 = \$1,588$$

Separate limit, passive income (Countries X & Y)

$$\frac{\$2,000}{\$30,000} \times 4,764 = \$312$$

Separate limit, FSC dividends

$$\frac{\$2,000}{\$30,000} \times 4,764 = \$312$$

Passive income. Passive income generally includes dividends, interest, rents, royalties, and annuities. It also includes gains from the sale of non-income-producing investment property or property that generates passive income. Gains from certain commodities transactions are included, except hedging and active business gains or losses of producers, processors, merchants, or handlers of commodities. Passive income also includes such income as undistributed foreign personal holding company income treated as dividends and amounts includible under section 1293 of the Internal Revenue Code (relating to certain passive foreign investment companies).

Passive income does not include gains from the sale of inventory property or property held mainly for sale to customers in the ordinary course of your trade or business. Passive income also does not include any income from the other separate limit categories or from export financing interest, high-taxed income, or active business rents and royalties from unrelated persons.

Export financing interest is derived from financing the sale (or other disposition) of property for use outside the United States if the property is manufactured or produced in the United States and not more than 50% of the value of the property is attributable to imports to the United States.

High-taxed income is passive income subject to foreign taxes in excess of the highest applicable U.S. tax rate. This income is moved from the passive income category into the general limitation income category.

High withholding tax interest. High withholding tax interest is interest (except export financing interest) that is subject to a foreign gross-withholding or gross-basis tax of at least

5%. If interest is not high withholding tax interest because it is export financing interest, it is usually general limitation income. However, if it is received by a financial services entity, it is financial services income.

Financial services income. Financial services income is, generally, any income received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, and which is:

Derived in the active conduct of a banking, financing, or similar business,

Passive income, or

Export financing interest which is subject to a foreign gross-withholding or gross-basis tax of at least 5%.

It also includes income from the investment by an insurance company of its unearned premiums or reserves. Financial services income does not include any export financing interest (except as noted above) or high withholding tax interest.

Shipping income. Shipping income is foreign base company shipping income (as defined in section 954(f) of the Internal Revenue Code). This is income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce. It also includes income from the sale, or other disposition, of these aircraft or vessels. Income from activities relating to space or the ocean are included. Shipping income that is both shipping and financial services income is treated as financial services income.

DISC dividends. This dividend income generally consists of dividends from an interest charge DISC or former DISC to the extent they are attributable to qualified export receipts.

FSC distributions. These are distributions out of earnings and profits attributable to foreign trade income.

Lump-sum distribution. If you receive a foreign-source lump-sum distribution (LSD) from a retirement plan, and you figure the tax on it using the special averaging treatment for LSDs, a special computation must be made. (The special averaging treatment for LSDs is elected by filing Form 4972, *Tax on Lump-sum Distributions*.)

Follow the Form 1116 instructions and complete the worksheet in those instructions to determine your foreign tax credit on the LSD.

General limitation income. This is income from sources outside the United States that does not fall into one of the other separate limit categories.

Rules for controlled foreign corporations. As a U.S. shareholder, certain income that you receive or accrue from a controlled foreign corporation (CFC) is treated as separate limit

income. You are considered a U.S. shareholder in a CFC if you own 10% or more of the total combined voting power of all classes of stock entitled to vote.

Subpart F inclusions, interest, rents, and royalties from a CFC are generally treated as separate limit income to the extent that they are attributable to the separate limit income of the CFC. A dividend paid or accrued out of the earnings and profits of a CFC is treated as separate limit income in the same proportion that the part of earnings and profits attributable to income in the separate category bears to the total earnings and profits of the CFC.

Partnerships. In general, a partner's distributive share of partnership income is treated as separate limit income to the extent it is attributable to the separate limit income of the partnership. However, if the partner owns less than 10% interest in the partnership, the income is generally treated as passive income.

Mutual funds. If you receive foreign source distributions from a mutual fund that elects to pass through to you the foreign tax credit, the income is generally considered passive. The mutual fund will need to provide you with this information.

Allocation of foreign taxes. If you have paid or accrued foreign income tax for a tax year on more than one separate limit income category, but the tax is not specifically allocable to any one of the items of income received, you must allocate the tax to each category of income.

You do this by multiplying the foreign income tax related to more than one category by a fraction. The numerator of the fraction is the net income of each of the separate limit categories. The denominator is the total net foreign income.

You figure net income by deducting from the gross income in each category and from the total foreign income any expenses, losses, and other deductions specifically allocable to them under the laws of the foreign country or U.S. possession. If the expenses, losses, and other deductions are not specifically allocated under foreign law, they are apportioned under the principles of the foreign law. If the foreign law does not provide for an allocation or apportionment, use the principles covered in the U.S. Internal Revenue Code.

Example. In 1994, you paid foreign income taxes of \$3,200 to Country A on wages of \$80,000 and interest income of \$3,000. These were the only items of income on your foreign return. You also have deductions of \$4,400 that, under foreign law, are not definitely related to either the wages or interest income.

Because the foreign tax is not specifically attributable to either item of income, you must allocate the tax between the wages and the interest under the tax laws of Country A. For purposes of this example, assume that the laws of Country A do this in a manner similar to section 861 of the U.S. Internal Revenue Code. First figure the net income in each category by allocating those expenses that are not definitely related to either category of income.

You figure the expenses allocable to wages (general limitation income) as follows:

$$\frac{\$80,000 \text{ (wages)}}{\$83,000 \text{ (total income)}} \times \$4,400 = \$4,241$$

The net wages are \$75,759 (\$80,000–\$4,241).

You figure the expenses allocable to interest (passive income) as follows:

$$\frac{\$3,000 \text{ (interest)}}{\$83,000 \text{ (total income)}} \times \$4,400 = \$159$$

The net interest is \$2,841 (\$3,000–\$159).

Then, to figure the foreign tax attributable to the wages, you multiply the total foreign income tax by the following fraction:

$$\frac{\$75,759 \text{ (net wages)}}{\$78,600 \text{ (total net income)}} \times \$3,200 = \$3,084$$

You figure the foreign tax attributable to the interest income as follows:

$$\frac{\$2,841 \text{ (net interest)}}{\$78,600 \text{ (total net income)}} \times \$3,200 = \$116$$

Foreign taxes from a partnership. If you are a partner in a partnership that has foreign income and the partnership paid or accrued foreign income tax, you will need to use certain information from the Form K–1 you received from the partnership. To compute your credit, you will need to refer to lines 17a through 17g on the Form K–1. Line 17e is the foreign tax that was paid or accrued on your behalf by the partnership. Any reductions to the foreign tax are shown on line 17f. On line 17c you will find your share of the partnership's gross income. Line 17d is the total applicable deductions and losses that reduce line 17c. You will need these figures to compute your foreign tax credit.

Subchapter S corporation. If you own stock in a Subchapter S corporation and receive a Form K–1 (1120S), you will find this information on lines 15a through 15g. Line 15e is the foreign tax that was paid or accrued on your behalf by the corporation. Any reductions to the foreign tax are shown on line 15f. On line 15c you will find your share of the corporation's gross income. Line 15d is the total applicable deductions and losses that reduce line 15c.

Figuring the Limit

You must figure your taxable income in each category from sources outside the United States and total taxable income from all sources before you can determine your limit on the credit. Your taxable income is gross income less applicable deductions.

For this computation, **do not include** in your gross income any earned income that is exempt from tax under the foreign earned income exclusion or the foreign housing exclusion. These exclusions from income are discussed in detail in Publication 54.

If you are self-employed, the type of business or profession you are in determines what you must include in gross income. If you are in a manufacturing, selling, or mining business, gross income is gross profit (gross receipts

less cost of goods sold). If you are in a business of providing services, then gross income is gross receipts.

Rules for Determining the Source of Income

Since the foreign tax credit applies to foreign source income, you must first determine whether your income is from U.S. sources or foreign sources. Some of the general rules for figuring the source of income are outlined in Table 3.

Rules for Determining Taxable Income From Sources Outside the United States

To figure your taxable income in each category from sources outside the United States, you first allocate to specific classes (kinds) of gross income the expenses, losses, and other deductions (including the deduction for foreign housing costs) that are **definitely related** to that income. A deduction is definitely related to a specific class of gross income if it is incurred as a result of, or incident to, an activity or in connection with a property from which that income is derived. For example, compensation for personal services, business income, or investment income may be classes of gross income.

When you allocate deductions that are definitely related to a specific class of gross income, you take exempt income into account for the allocation. However, do not take exempt income into account to apportion deductions to items within a class of income. You must allocate and apportion your interest expense and state income taxes under the special rules discussed later under *Interest expense* and *State taxes*.

If the class of gross income to which a deduction definitely relates includes one or more separate limit categories, or one or more separate limit categories and U.S. source income, you then **must apportion** the definitely

related deductions within that class of gross income.

To apportion, you can use any method that reflects a reasonable relationship between the deduction and the income in each separate limit category. One acceptable method for many individuals is based on a comparison of the gross income in a class of income to the gross income in a separate limit income category.

Use the following formula to figure the amount of the definitely related deduction apportioned to the income in the separate limit category:

$$\frac{\text{Gross income in separate limit category}}{\text{Total gross income in the class}} \times \text{deduction}$$

You do not take exempt income into account when you apportion the deduction. However, income excluded under the foreign earned income or foreign housing exclusion is **not considered exempt**. You must, therefore, apportion deductions to that income.

Interest expense. Generally, you must apportion interest expense under the following special rules. However, if you have gross foreign source income (including income that is excluded under the foreign earned income exclusion) of \$5,000 or less, you do not apportion interest under the following rules. Your interest expense can be allocated entirely to domestic source income.

The Instructions for Form 1116 have a worksheet for apportioning your deductible home mortgage interest expense.

Interest incurred in a trade or business is apportioned using the asset method based on your business assets.

Under the asset method, you apportion the interest expense to your separate limit categories based on the value of the assets that produced the income. You can value assets at fair market value or the tax book value.

Investment interest is apportioned on the basis of your investment assets.

Interest incurred in a passive activity is apportioned on the basis of your passive activity assets.

Table 3. Source of Income

Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services performed
Business income:	
Personal services	Where services performed
Sale of inventory	Where sold
Interest	Residence of payer
Dividends	Whether a U.S. or foreign corporation
Rents	Location of property
Royalties:	
Natural resources	Location of property
Patents, copyrights, etc.	Where property is used
Sale of real property	Location of property
Sale of personal property	Seller's residence (but see the discussion under <i>Capital Gains and Losses</i> , later, for exceptions)
Pensions	Where services were performed that earned the pension

Qualified residence interest is apportioned under a gross income method, taking into account all income (including business, passive activity, and investment income), but excluding income that is exempt under the foreign earned income exclusion. Qualified residence interest is your **deductible home mortgage interest** from Schedule A (Form 1040). The gross income method is based on a comparison of the gross income in a separate limit category with total gross income.

For this purpose, however, any qualified residence that is rented is considered a business asset for the period in which it is rented. You therefore apportion this interest under the rules for passive activity or trade or business interest.

Example. You are engaged in a business that you operate as a sole proprietorship. Your business generates only U.S. source income. Your investment portfolio consists of several less than 10% stock investments. You have stocks with an adjusted basis of \$100,000. Some of your stocks (with an adjusted basis of \$40,000) generate U.S. source income; your other stocks (with an adjusted basis of \$60,000) generate foreign passive income. You also own your personal residence, which is subject to a mortgage of \$120,000. Interest on this loan is qualified residence interest. You also have a bank loan in the amount of \$40,000. The proceeds were divided equally between your business and your investment portfolio. Your gross income in your business is \$50,000. Your investment portfolio generated \$4,000 in U.S. source income and \$6,000 in foreign source passive income. All of your debts bear interest at the annual rate of 10%.

The \$2,000 interest expense attributable to your business is apportioned on the basis of the business assets. All of your business assets generate U.S. source income; therefore, they are U.S. assets. The \$2,000 in interest expense on the business loan is allocable to U.S. source income.

The \$2,000 interest expense attributable to your investments is apportioned on the basis of investment assets. Your assets consist of stock (adjusted basis, \$40,000) generating U.S. source income and stock (adjusted basis, \$60,000) generating foreign source passive income. Thus, 40% (\$40,000/\$100,000 × \$2,000) or \$800 of your investment interest is apportioned to U.S. source income and 60% (\$60,000/\$100,000 × \$2,000) or \$1,200 is apportioned to foreign passive income for purposes of figuring the limit on the foreign tax credit.

The \$12,000 qualified residence interest expense is apportioned on the basis of all your gross income. Your gross income consists of \$60,000, \$54,000 of which is U.S. source income and \$6,000 of which is foreign source passive income. Thus, \$1,200 (\$6,000/\$60,000 × \$12,000) of the qualified residence interest is apportioned to foreign source passive income.

State taxes. State income taxes (and certain taxes measured by taxable income) are definitely related and allocable to the gross income on which the taxes are imposed. If you

pay this state tax and it is imposed in part on foreign source income, the part of your state tax attributable to foreign source income is definitely related and allocable to foreign source income.

If the state does not specifically exempt foreign income from tax, the deduction for state taxes may be allocable to a class of gross income that includes foreign source income.

If the total income taxed by the state is greater than the amount of U.S. source income for federal tax purposes, then the state tax is allocable to a class of gross income that includes foreign source income.

If the total income taxed by the state is less than or equal to the U.S. source income for federal tax purposes, none of the state tax is allocable to a class of gross income that includes foreign source income.

If state law specifically exempts foreign income from tax, the state taxes are definitely allocable to the U.S. source income.

If you find that these methods do not result in a proper allocation of state income taxes, you can make any other reasonable allocation that will, in the opinion of the District Director, more clearly reflect the proper allocation.

Example. Your total income for federal tax purposes, before deducting state tax, is \$100,000. Of this amount, \$25,000 is foreign source income and \$75,000 is U.S. source income. You pay state income tax of \$6,000 on a total income of \$90,000. The state does not specifically exempt foreign source income from tax. The total state income of \$90,000 is greater than the U.S. source income for federal tax purposes. Therefore, the \$6,000 is definitely related and allocable to a class of gross income that includes foreign source income.

You apportion the tax between U.S. source and foreign source income in that class of gross income. In these facts, you may presume that \$15,000 (\$90,000 – \$75,000) is the foreign source income taxed by the state. Then, \$1,000 of state income tax is apportioned to foreign source income, figured as follows:

$$\frac{\$15,000}{\$90,000} \times \$6,000 = \$1,000$$

Deductions not definitely related. You must apportion to your foreign income in each separate limit category **a fraction** of your other expenses that are not definitely related to a specific class of gross income. These deductions are medical expenses, charitable contributions, real estate taxes for your home, alimony payments, or, if you do not itemize, the standard deduction. The **numerator** of the fraction is your gross foreign income in the separate limit category, and the **denominator** is your total gross income from all sources. For this purpose, gross income includes income that is excluded under the foreign earned income provisions.

Itemized deduction limit. For 1994, you may have to reduce your itemized deductions if your adjusted gross income is more than

\$111,800 (\$55,900 if married filing separately). This reduction does not apply to medical and dental expenses, casualty and theft losses, gambling losses, and investment interest.

You figure the reduction by using the Itemized Deduction Worksheet in the instructions for Schedule A (Form 1040). Line 3 of the worksheet shows the total itemized deductions subject to the reduction. Line 9 shows the amount of the reduction.

To determine your taxable income from sources outside the United States, you must first divide the reduction (line 9 of the worksheet) by the deductions subject to the reduction (line 3 of the worksheet). This is your reduction percentage. Then, reduce the deduction shown on Schedule A (Form 1040) by your reduction percentage to determine the amount you can allocate to income from sources outside the United States.

Example. You are single and have an adjusted gross income of \$150,000. Your itemized deductions other than medical and dental expenses, casualty and theft losses, gambling losses, and investment interest total \$20,000. This is the amount on line 3 of the worksheet. The amount on line 9 is \$1,146 (\$38,200 × 3%).

You have a charitable contribution deduction of \$12,000 shown on Schedule A (Form 1040) that is subject to the reduction. Your reduction percentage is 5.7% (\$1,146/\$20,000). You must reduce your \$12,000 deduction by \$684 (5.7% × \$12,000). The reduced deduction, \$11,316 (\$12,000 – \$684), is used to determine your taxable income from sources outside the United States.

Treatment of personal exemptions. Do not take the deduction for personal exemptions, including exemptions for dependents, in figuring **taxable income from sources outside the United States**.

Taxable income from all sources. You also figure your total taxable income from all sources without regard to personal exemptions. You get this figure from line 35, Form 1040.

U.S. tax liability. You figure your U.S. tax liability against which you apply your allowable credit, and that you use in figuring the credit, on your taxable income, that takes into account the deduction for personal exemptions and exemptions for dependents. You use the amount on line 40, Form 1040, **less** any amounts on lines 41 and 42, and any mortgage interest credit on line 44, of Form 1040.

Example. Chris Smith is single, under 65, and has been a bona fide resident of Country A for 5 years. In 1994 Chris earned a salary of \$85,000 in Country A. He also had interest income of \$5,000 from investments in that country on which he paid an investment counseling fee of \$700. Chris paid income tax to Country A on these amounts. In addition, he received \$5,000 dividend income from sources in the United States. Chris contributed \$500 to his church and other charitable organizations in the United States. He paid \$1,500 real estate

Table 4. Chris Smith

Chris computes his Form 1040 U.S. tax liability as follows.

A. Income Subject to U.S. Tax

1) Salary (Country A)	\$85,000
2) Less: Foreign earned income exclusion	70,000
3) Salary includible in U.S. federal tax return	\$15,000
4) Interest (Country A)	5,000
5) Dividends (United States)	5,000
6) Adjusted gross income	\$25,000

B. Less: Itemized Deductions

1) Itemized deductions	
a) Contributions (United States)	\$ 500
b) Taxes on residence (Country A)	1,500
c) Interest on residence (Country A)	2,500
d) Investment counselling fee (Country A) (\$700 - 500, 2% of AGI)	200
e) Total itemized deductions	4,700

C. Taxable Income Before Personal Exemption

\$20,300

D. Less: Personal Exemption

2,450

E. Taxable Income

\$17,850

F. U.S. Tax Liability from Tax Table under Single Column

\$2,681

Chris computes his Form 1116 taxable general limitation income from Country A as follows.

G. Computation of Taxable Income from Country A (General Limitation Income)

1) General limitation income from Country A includible in U.S. federal income tax return (Line A(3))	\$15,000
2) Less: Residence interest allocable to general limitation income (Line B(1)(c))	
\$15,000	
\$25,000 × \$2,500	1,500
3) Total itemized deductions	\$4,700
4) Less: Itemized deductions definitely allocable to specific income items (Lines B(1)(c) and (d))	2,700
5) Itemized deductions not definitely allocable to specific income items	\$2,000
6) Ratable part of \$2,000 applicable to general limitation income	
\$85,000 (Lines A(2) and G(1))	
\$95,000 (Lines A(2) and A(6)) × \$2,000	1,789
7) Total deductions allocable to general limitation income	3,289
8) Taxable income in general limitation income category	\$11,711

Chris computes his Form 1116 taxable passive income from Country A as follows. (A separate Form 1116 is needed for each category of income.)

H. Computation of Taxable Income from Country A (Passive Income)

1) Passive income from Country A includible in U.S. federal income tax return (Line A(4))	\$5,000
2) Less: Expenses definitely allocable to passive income (Line B(1)(d))	\$200
3) Less: Residence interest allocable to passive income (Line B(1)(c))	
\$5,000	
\$25,000 × \$2,500	500
4) Total itemized deductions	\$4,700
5) Less: Itemized deductions definitely allocable to specific income items (Lines B(1)(c) and (d))	2,700
6) Itemized deductions not definitely allocable to specific income items	\$2,000
7) Ratable part of \$2,000 applicable to income category	
\$5,000 (Lines A(4))	
\$95,000 (Lines A(2) and A(6)) × \$2,000	105
8) Total deductions allocable to passive income	805
9) Taxable income in passive income category	\$4,195

Chris computes his credit limit for each category of income. (See discussion of this calculation earlier under *Limit on the Credit*.)

I. Computation of Taxable income from All Sources for Purposes of the Foreign Tax Credit

1) Taxable income from all sources (Line C)	\$20,300
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J. Computation of the Limit on Foreign Tax Credit Allowable (General Limitation Income)

\$11,711 (Line G(8))	
\$20,300 (Line I(1)) × \$2,681 (Line F)	\$ 1,547

K. Computation of the Limit on Foreign Tax Credit Allowable (Passive Income)

\$4,195 (Line H(9))	
\$20,300 (Line I(1)) × \$2,681 (Line F)	\$ 554

Chris' income subject to U.S. tax is the total received from all the sources mentioned previously. However, from the \$85,000 salary received in Country A, he excludes \$70,000 under the foreign earned income exclusion. His adjusted gross income is \$25,000. Chris' salary is in the general limitation income category. His interest income is in the passive category. Therefore, he needs to figure two limits. The limit on the amount of foreign taxes that Chris may credit on his salary and interest income in 1994 is \$1,547 and \$554, respectively, as shown in **Table 4**.

Capital Gains and Losses

If you have a foreign source capital gain or loss and used the Capital Gain Tax Worksheet in the Instructions for Form 1040, you will need to adjust the gain or loss. See *Maximum capital gains tax*, later.

Foreign capital gain. Your taxable income from foreign sources in a separate limit category (the numerator of the limiting fraction) includes gains from the sale or exchange of capital assets only to the extent of **foreign source capital gain net income**. Your taxable income from all sources (the denominator of the fraction) includes gains from the sale or exchange of capital assets only to the extent of **capital gain net income**.

Foreign source capital gain net income for a separate limit category is the lesser of:

- 1) Capital gain net income from foreign sources in the separate limit category, or
- 2) Capital gain net income from all sources in that category.

Capital gain net income is the excess of your gains from sales or exchanges of capital assets over your losses from sales or exchanges of capital assets. This includes net section 1231 gain, but does not include gain from the sale or exchange of capital assets to the extent the gain is not treated as capital gain.

Capital asset. Generally, everything you own and use for personal purposes or investment is a capital asset. Some examples are: stocks or bonds held in your personal account; a home owned and occupied by you and your family; household furnishings; a car used for pleasure or commuting; coin or stamp collections; gems and jewelry; gold, silver or any other metal.

Net section 1231 gain. Property used in a trade or business or held for the production of rents or royalties and held more than one year, and any other property held for more than one year that is subjected to an involuntary conversion, is known as section 1231 property. You combine all gains and losses from the sales and dispositions of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. (For more information on these gains, see Publication 544, *Sales and Other Dispositions of Assets*.)

Example. You are a U.S. citizen and reside in Country X during 1994. You had a \$10,000 long-term capital gain and a \$2,000

taxes on his residence in Country A, and deductible interest of \$2,500 on his mortgage in Country A.

long-term capital loss from sales of foreign corporate stock through Country X's stock exchange. This is income in the passive category. You also had a \$6,000 long-term capital loss from U.S. sources. Your foreign source capital gain net income is \$2,000, the lesser of (1) or (2):

1) Capital gain net income from foreign sources:	
Long-term capital gain—Country X	\$10,000
Long-term capital loss—Country X	(2,000)
Capital gain net income from foreign sources (passive income category)	<u>\$ 8,000</u>
2) Capital gain net income from all sources:	
Long-term capital gain—Country X	\$10,000
Long-term capital loss—Country X	(2,000)
Long-term capital loss—U.S.	(6,000)
Capital gain net income from all sources	<u>\$ 2,000</u>

When figuring the limit in your passive income category, the amount to include in the numerator of the limiting fraction is \$2,000. The amount to include in the denominator is also \$2,000, capital gain net income from all sources.

If you used the Capital Gain Tax Worksheet in the Instructions for Form 1040 to figure your tax, you will need to adjust the amount of capital gain that you include in the fraction. See *Maximum capital gains tax*, later, for information on this adjustment.

Foreign capital loss. Your taxable income from foreign sources in a separate limit category (the numerator of the limiting fraction) is reduced by any net capital loss from foreign sources in that category, to the extent taken into account in figuring your capital gain net income. For this purpose, net capital loss is the excess of losses from the sale or exchange of capital assets (that are treated as capital losses) and any capital loss carryover, over the capital loss deduction limit for the tax year. When figuring net capital loss, include gains and losses that are not from the sale or exchange of capital assets but that are treated as capital gains and losses, such as net section 1231 gains.

If you used the Capital Gain Tax Worksheet in the Instructions for Form 1040 to figure your tax, see *Maximum capital gains tax*, later, for information on an adjustment you will need to make.

Sales or exchanges of certain personal property. The source of income from the sale, exchange, or other disposition of personal property depends on the type of property.

Income from the sale of tangible or intangible personal property is generally sourced in the country of the seller's residence. If personal property is sold by a U.S. resident, the income from the sale is generally treated as U.S. sourced. If sold by a nonresident, the income is generally treated as foreign sourced.

A U.S. resident, for this purpose, is a U.S. citizen or resident alien who does not have a tax home in a foreign country or a nonresident alien who has a tax home in the United States. Generally, your tax home is the general area of your main place of business, employment, or post of duty, regardless of where you maintain your family home. Your tax home is the place where you are permanently or indefinitely engaged to work as an employee or self-employed individual. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit either of these categories, you are considered an itinerant and your tax home is wherever you work. A nonresident is any person other than a U.S. resident.

Exception. U.S. citizens and resident aliens will not be treated as nonresidents for a sale of personal property **unless** an income tax of at least 10% of the gain on the sale is paid to a foreign country.

Inventory. Income from the sale of inventory property is generally sourced where the title to the property passes.

Intangibles. Income from the sale of intangible property (such as a patent, copyright, trademark, or goodwill) that is contingent on the productivity, use, or disposition of the property is sourced in the country where the property is used. Payments for goodwill are sourced in the country where the goodwill was generated.

Depreciable property. The gain from the sale of depreciable personal property, up to the amount of the previously allowable depreciation, is sourced in the same way as the original deductions were sourced. Thus, to the extent the previous deductions for depreciation were allocable to U.S. source income, the gain is U.S. source, and to the extent the depreciation deductions were allocable to foreign sources, the gain is foreign source income. Gain in excess of the depreciation deductions is sourced the same as inventory property, where the title to the property passed.

However, **if personal property is used predominantly in the United States**, the gain from the sale, to the extent of the allowable depreciation deductions, is treated entirely as U.S. source income.

If the property is used **predominantly outside the United States**, the gain, to the extent of the depreciation deductions, is treated entirely as foreign source income.

Depreciation includes amortization and any other allowable deduction that treats a capital expenditure as a deductible expense.

Sales through foreign office or fixed place of business. Income earned by U.S. residents from the sale of personal property through an office or other fixed place of business outside the United States is generally treated as foreign source if:

- 1) The income from the sale is attributable to the business operations located outside the United States, and
- 2) At least 10% of the income is paid as tax to the foreign country.

If less than 10% is paid as tax, the income is U.S. source.

This rule does **not** apply to income sourced under the rules for inventory property, depreciable personal property, intangible property (when payments in consideration for the sale are contingent on the productivity, use, or disposition of the property), or goodwill.

Maximum capital gains tax. If you compute your tax for 1994 using the Capital Gain Tax Worksheet in the Instructions for Form 1040, you need to adjust the denominator of the limiting fraction used in figuring your foreign tax credit. If you had a foreign source capital gain or loss, you also need to adjust the numerator.

The instructions for Form 1116 contain worksheets for figuring the adjustments. To adjust the denominator, use the worksheet in the instructions for line 17 of Form 1116.

To adjust the numerator, you must first complete a separate Schedule D for your foreign source capital gains and losses. This is your "foreign Schedule D." If line 18 of your foreign Schedule D shows a gain, complete the *Worksheet for Capital Gains*. If line 18 shows a loss, complete the *Worksheet for Capital Losses*. Use your foreign Schedule D only to compute the limit. Do **not** file it with your return.

Example. You use the Capital Gain Tax Worksheet in the Instructions for Form 1040 to compute your tax. Your capital gains include a \$6,000 foreign source long-term capital gain. You must complete a separate Schedule D (foreign Schedule D) for your foreign source gain. The lines needed to complete the worksheets are as follows.

- 1) Schedule D filed.
 - a) Line 17.....\$5,000
 - b) Line 18..... 8,000
 - c) Line 2..... 5,000 (Capital Gain Tax Worksheet)
- 2) Foreign Schedule D.
 - a) Line 17.....\$6,000
 - b) Line 18..... 6,000
 - c) Line 2..... 6,000 (Capital Gain Tax Worksheet)

Since line 18 of your foreign Schedule D is a gain, you would complete the *Worksheet for Capital Gains*, as follows.

Worksheet for Capital Gains

Note: If you were not required to file Schedule D, but reported capital gain distributions on Form 1040, line 13, compare your foreign capital gain distributions with your total capital gain distributions and enter the smaller of the two amounts on line 1 of the Worksheet.

1. Compare line 18 of your foreign Schedule D with line 18 of the Schedule D you are filing with your tax return. (Estates and trusts should use line 17 from Schedule D (Form 1041)). Enter the smaller of the two amounts. This is your foreign source capital gain net income. (If a loss appears on line 18 (line 17 on Schedule D (Form 1041)) of your foreign Schedule D, do not complete the rest of the worksheet. Instead, use the *Worksheet for Capital Losses* below.) **Note:** If the amount on line 17 (line 16 on Schedule D (Form 1041)) of your foreign Schedule D is zero or a loss, do not complete the rest of the worksheet. The amount on line 1 of the worksheet is the amount to include as capital gain on line 1, Form 1116 \$6,000
2. Compare line 2 of your foreign Capital Gain Tax Worksheet with line 2 of the Capital Gain Tax Worksheet you used to figure the tax for your return. (Estates and trusts should use line 37a from Schedule D (Form 1041)). Enter the smaller of the two amounts. This is your foreign source net capital gain.* 5,000
3. Multiply line 2 by .2929 1465
4. Subtract line 3 from line 1. This is the amount to include as capital gain on line 1, Form 1116 \$4,535

*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment income limitation.

You include the amount on line 4 of this worksheet on line 1, Form 1116. Combine this amount with any other amount you have in this separate income limit category to determine the numerator of the limiting fraction.

If, when you completed your foreign Schedule D, it showed a \$6,000 loss on line 18, you would complete the following worksheet.

Worksheet for Capital Losses

1. Enter your net capital loss from foreign sources (to the extent taken into account in determining capital gain net income) \$6,000
2. Enter net capital gain* from sources within the United States. (This is the excess of net long-term capital gains from U.S. sources over net short-term capital losses from U.S. sources.) 11,000
3. Enter the amount (net capital gain)* from line 2 of the Capital Gain Tax Worksheet you used to figure the tax for your return. (Estates and Trusts should use line 37a of Schedule D (Form 1041)). 5,000
4. Subtract line 3 from line 2 6,000
5. Multiply line 4 by .2929 1,757
6. Subtract line 5 from line 1. This is your net capital loss from foreign sources. Enter this amount here and on line 5 of Form 1116 \$4,243

*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment income limitation.

You include the amount on line 6 of this worksheet on line 5, Form 1116, to determine the numerator.

Form 1116, Line 17. Because you compute your tax using the Capital Gain Tax Worksheet, you must adjust the denominator of the limiting fraction. You must complete the Worksheet for Line 17 of Form 1116, even if you did not have a foreign source capital gain or loss. The amount on line 35, Form 1040, is \$90,000.

Worksheet for Line 17 of Form 1116

1. Enter the amount (net capital gain)* from line 2 of the Capital Gain Tax Worksheet used to figure the tax for your return. Estates and trusts: Enter the amount from line 37a of Schedule D (Form 1041) \$5,000
2. Individuals: Enter the amount from Form 1040, line 35. Estates and trusts: Enter taxable income without the deduction for your exemption \$90,000
3. Multiply line 1 by .2929 1,465
4. Subtract line 3 from line 2. Enter the result here and on Form 1116, line 17 \$88,535

*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment income limitation.

You include the amount on line 4 of this worksheet on line 17, Form 1116, for all separate income limit categories.

More than one category. If you have foreign source capital gains and losses that are from more than one separate limit income category, you must complete a foreign Schedule D, as discussed earlier, showing all your foreign capital gains and losses for all the categories. Then, depending on whether you have a gain or a loss on line 17 of your foreign Schedule D, use whichever of the following procedures apply.

Gain. If line 17 of your foreign Schedule D is a gain, complete the Worksheet for Capital Gains in the Form 1116 instructions through line 3. This is your adjustment amount.

If you have a gain in each category, allocate the adjustment amount based on what percent of the total gain is represented by the gain in a particular category. For example, you have a total gain of \$25,000 of which \$5,000 is from the general limitation category. You determine that your adjustment amount is \$2,420. Therefore, you must allocate 20% (\$5,000/\$25,000) of the adjustment amount, \$484, to that category. On the Form 1116 that you complete for the general limitations category, you would include \$4,516 (\$5,000–\$484) as your capital gain on line 1.

If you have gains in some categories and losses in other categories, allocate the adjustment amount to only the categories with gains. If more than one category has a gain, follow the procedure in the previous paragraph.

Loss. If line 17 of your foreign Schedule D is a loss, complete the Worksheet for Capital Losses in the Form 1116 instructions through line 5. This is your adjustment amount.

If you have a loss in each category, allocate the adjustment amount based on what percent of the total loss is represented by the loss in a particular category.

If you have losses in some categories and gains in other categories, allocate the adjustment amount to only the categories with losses. If more than one category has a loss, follow the procedure in the previous paragraph.

Allocation of Foreign Losses

If you have a foreign loss when figuring your taxable income in a separate limit income category, and you have income in one or more of the other separate categories, you must first reduce the income in these other categories by the loss before reducing income from U.S. sources.

Example. In 1994, you have \$10,000 of income in the passive income category and incur a loss of \$5,000 in the general limitation income category. You use the \$5,000 loss to offset \$5,000 of the income in the passive category.

How to allocate. Foreign losses must be allocated among the separate limit income categories in the same proportion as each category's income bears to total foreign income.

Example. In 1994, you have a \$2,000 loss in the general limitation income category, \$3,000 of passive income, and \$2,000 in distributions from a FSC. You must allocate the foreign loss to the income in the other separate

categories. Sixty percent [\$3,000/\$5,000] of the \$2,000 loss (or \$1,200) reduces passive income and forty percent [\$2,000/\$5,000] or \$800 reduces FSC distributions.

If you have a loss remaining after reducing the income in other separate limit categories, this excess then reduces U.S. source income. When you use a foreign loss to offset U.S. source income, you must recapture the loss as explained later under *Recapture of Foreign Losses*.

Recharacterization of subsequent income in a loss category. If a loss in one separate limit category is used to reduce income in another category or categories, and the loss category has income in a subsequent tax year, all or part of the income from this former loss category is recharacterized as income in the category (or categories) that was previously reduced by the loss. The tax, however, is not recharacterized.

Example. Using the same facts as in the previous example, in 1995 you have \$4,000 of passive income, \$1,000 in FSC distributions, and \$5,000 of general limitation income. Since \$1,200 of the general limitation loss was used to reduce your passive income in the previous year, \$1,200 of the current year's general limitation income of \$5,000 must be recharacterized as passive income. This makes the current year's total of passive income \$5,200. Similarly, \$800 of the general limitation income must be recharacterized as FSC distributions, making the current year's total of FSC distributions \$1,800. The total income in the general limitation category is then \$3,000.

U.S. losses. Any net loss from sources in the United States must be allocated among the different categories of foreign income **after**:

- 1) The allocation of all foreign losses (described above),
- 2) The recapture of a prior year overall foreign loss (described below), and
- 3) The recharacterization of income (described above).

Recapture of Foreign Losses

If you have only losses in your separate limit categories, or if you have a loss remaining after allocating your foreign losses to other separate categories, you have an overall foreign loss. If you use this loss to offset U.S. source income (resulting in a reduction of your U.S. tax liability), you must recapture your loss in each succeeding year in which you have taxable income from foreign sources.

You make the recapture by treating part of your taxable income from foreign sources in a recapture year as U.S. source income. In addition, if you dispose of property used in your foreign trade or business, you may be **deemed** to have had a gain on the disposition (sale, gift, etc.) because of the recapture-of-foreign-losses provision. The amount treated as U.S. source income reduces the numerator of the limiting fraction (foreign source income), and therefore reduces the foreign tax credit limit.

You must establish separate accounts for each type of foreign loss that you sustain. The balances in these accounts are the overall foreign loss subject to recapture. These balances are reduced at the end of each tax year by the loss that you recaptured. You must attach a statement to your Form 1116 to report the balances (if any) in your overall foreign loss accounts.

Overall foreign loss. An overall foreign loss is the amount by which your gross income from foreign sources for a tax year is exceeded by the sum of your deductions that are directly related to that are allocated to the income. You must allocate to the income a ratable part of any expenses, losses, or other deductions, such as itemized deductions, or the standard deduction if you do not itemize, which are not directly related to an item or class of gross income. You must recapture the overall loss regardless of whether you chose to claim the foreign tax credit for the loss year.

Example. For 1994, you are single and have gross dividend income of \$10,000 from U.S. sources. You also have a greater than 10% interest in a foreign partnership in which you materially participate. The partnership has a loss for the year, and your distributive share of the loss is \$15,000. Your share of the partnership's gross income is \$100,000, and your share of its expenses is \$115,000. Your only foreign source income is your share of partnership income which is in the general limitation income category. You are a bona fide resident of a foreign country and you elect to exclude your foreign earned income. You exclude the maximum \$70,000. You also have itemized deductions of \$4,700 that are not directly related to any item of income.

In figuring your overall foreign loss in the general limitation category for 1994, you must allocate a ratable part of the \$4,700 in itemized deductions to the foreign source income. You figure the ratable part of the \$4,700 that is attributable to foreign source income, based on gross income, as follows:

$$\frac{\$100,000 \text{ (Foreign gross income)}}{\$110,000 \text{ (Total gross income)}} \times \$4,700 = \$4,273$$

Therefore, your **overall foreign loss** for the year is \$8,773, figured as follows:

Foreign gross income	\$100,000
Less: Foreign earned income exclusion	\$70,000
Allowable directly related expenses (\$30,000/100,000 × \$115,000)	34,500
Ratable part of itemized deductions	4,273	108,773
Overall foreign loss	\$ 8,773

You do not consider the following in figuring an overall foreign loss in a given year:

- 1) Net operating loss deduction,
- 2) Foreign expropriation loss not compensated by insurance or otherwise, and

- 3) Casualty or theft loss not compensated by insurance or other arrangement.

Losses excepted from overall foreign loss recapture rules. There is one type of foreign source loss that is excepted from the recapture rules. This is a loss on the sale, exchange, or other disposition of bonds, notes, or other evidences of indebtedness issued before May 14, 1976, by a foreign government or instrumentality for the acquisition of:

- 1) Property located in that country, or
- 2) Stock or indebtedness of a corporation created or organized in or under the laws of that foreign country.

Recapture provision. If you have an overall foreign loss for any tax year and use the loss to offset U.S. source income, part of your taxable income from foreign sources for each succeeding year is treated as U.S. source taxable income. The part that is treated as U.S. source income is the **least** of:

- 1) The balance in the applicable overall foreign loss account (to the extent not treated as U.S. source income in a prior tax year),
- 2) 50% (or a larger percentage that you can choose) of your taxable income from foreign sources for the succeeding tax year, or
- 3) The foreign source taxable income in the former loss category after the allocation of foreign losses (discussed earlier).

Example. During 1993 and 1994, you are single and a 20% general partner in a partnership that derives its income from Country X. You also receive dividend income from U.S. sources during those years.

For 1993, the partnership had a loss and your share was \$20,000, consisting of \$80,000 gross income less \$100,000 expenses. Your net loss from the partnership is \$2,500, after deducting the foreign earned income exclusion and directly related allowable expenses. This is income in the general limitation category. Your U.S. dividend income was \$20,000. Your itemized deductions totaled \$4,000 and were not definitely related to any item of income. In figuring your taxable income for 1993, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 1994, the partnership had net income from Country X. Your share of the net income was \$40,000, consisting of \$100,000 gross income less \$60,000 expenses. Your net income from the partnership is \$12,000, after deducting the foreign earned income exclusion and the directly related allowable expenses. This is income in the general limitation category. You also received dividend income of \$20,000 from U.S. sources. Your itemized deductions were \$6,000, which are not directly related to any item of income. You paid income taxes of \$4,000 to Country X on your share of the partnership income.

When figuring your foreign tax credit for 1994, you must find the foreign source taxable

income that you must treat as U.S. source income because of the foreign loss recapture provisions.

You figure the foreign taxable income that you must recapture as follows:

A. Determination of 1993

Overall Foreign Loss

- 1) Partnership loss from Country X \$ 2,500
- 2) Add: Part of itemized deductions allocable to gross income from Country X—

$$\frac{\$ 80,000}{\$ 100,000} \times \$ 4,000 = \$ 3,200$$

- 3) Overall foreign loss for 1993 \$ 5,700

B. Amount of Recapture for 1994

- 1) General category foreign loss to the extent not previously recaptured \$ 5,700
- 2) 50% of 1994 taxable income from foreign sources—
Foreign source taxable income \$12,000
Less: Itemized deductions allocable to foreign source taxable income (\$100,000/\$120,000 × \$6,000) 5,000
Taxable income from foreign sources \$ 7,000
50% of taxable income subject to recapture \$ 3,500
- 3) Taxable income in general limitation category after allocation of foreign losses—General limitation taxable income \$12,000
Less: Itemized deductions allocable to that income (\$100,000/\$120,000 × \$6,000) 5,000
General limitation taxable income less allocated foreign losses— (\$7,000 – 0) \$ 7,000
- 4) Recapture for 1994 (least of (1), (2), or (3)) \$ 3,500

The amount of the recapture is shown on line 15, Form 1116.

Recapturing more overall foreign loss than required. If you want to make an election or change a prior election to recapture a greater part of the balance of an overall foreign loss account than the 50% that is required (as discussed above), you must attach a statement to your Form 1116 making the election. If you change a prior year's election, you should file an amended tax return.

The statement attached to Form 1116 must show:

The percentage and amount of your foreign taxable income that is being treated as U.S. source income, and

The balance (both before and after the recapture) in the overall foreign loss account that is being recaptured.

Deduction for foreign taxes. You can recapture part (or all, if applicable) of an overall foreign loss in tax years in which you deduct,

rather than credit, your foreign taxes. The recapture is applied to the extent of the lesser of:

- 1) The balance in the applicable overall foreign loss account, or
- 2) The difference between the foreign source taxable income of the same limitation type that resulted in the overall foreign loss and the foreign taxes imposed on that income.

Special rules. If you had an overall foreign loss account at the end of your last tax year beginning before 1987, there are special rules for recapturing the balance in subsequent years. You recapture the balance from the **separate limit income category** in effect after 1986 that is comparable to the income category for which the loss account was established. For example, if you have a balance in your overall foreign loss account in the former nonbusiness interest income category, you will recapture this loss from the current passive income category.

Overall foreign losses in the former general limitation income category (all other) are recaptured from your current general limitation, financial services, and shipping income categories.

If the total of these categories subject to the recapture is more than the overall foreign loss to be recaptured, then the amount of each type of separate limit income that is treated as U.S. source income is figured by multiplying the overall foreign loss subject to recapture by a **fraction**.

The **numerator** of the fraction is the income in each separate category from which the loss may be recaptured. The **denominator** is the total income of all the separate categories from which the loss may be recaptured. However, if you can show that the loss is attributable to one or more separate limit categories in effect after 1986, then you can recapture the loss from those separate categories only. This recapture is made after you have allocated your foreign losses and before the recharacterization of subsequent income, as discussed earlier.

When to recapture. An overall foreign loss incurred in a tax year beginning before 1987 is recaptured before an overall foreign loss incurred in tax years after 1986.

Dispositions. If, before you have fully recaptured an overall foreign loss, you dispose of trade or business property used predominantly outside the United States, the disposition is subject to the recapture rules. You are deemed to have received and recognized foreign taxable income in the year you dispose of the property.

The foreign source income that you are deemed to have received and recognized on the property and that you must treat as U.S. source income is 100% of the lesser of:

- 1) The excess of the fair market value of the property over your adjusted basis, or
- 2) The remaining amount of the overall foreign loss not treated as U.S. source income in the current year or any prior tax year.

Predominant use outside U.S. You determine whether property was used predominantly (more than 50% of the time) outside the United States by counting its use during the 3-year period ending on the date of disposition. If you used the property fewer than 3 years, count the use during the period it was used in a trade or business.

Disposition defined. A disposition includes a sale, exchange, distribution, or gift of property, whether or not gain or loss is normally recognized on the transfer. The character of the income recognized solely because of the disposition rules is the same as if you had sold or exchanged the property. Adjustments to the basis of property to reflect taxable income recognized will be allowed as provided by future regulations.

However, a disposition of property **does not include** property that is not a material factor in producing income.

Carryback and Carryover

If, because of the limit on the credit, you cannot use the full amount of qualified foreign taxes paid or accrued in the tax year, you are allowed a 2-year carryback and then a 5-year carryover of the unused foreign taxes.

This means that you can treat the unused foreign tax of a tax year as though the tax were paid or accrued in your 2 preceding and 5 succeeding tax years up to the amount of any excess limit in those years. A period of less than 12 months for which you make a return is considered a tax year.

The **unused foreign tax** in each category is the excess of qualified taxes paid or accrued over the amount of the limit for that category. The **excess limit** in each category is the amount by which the limit exceeds the qualified taxes paid or accrued for that category.

Your carrybacks or carryovers are figured separately for each separate limit income category.

The mechanics of the carryback and carryover are illustrated by the following examples.

Example 1. All your foreign income is in the general limitation income category. The limit on your credit and the qualified taxes paid to Country X are as follows:

	Your limit	Tax Paid	Unused foreign tax (+) or excess limit (–)
1992	\$100	\$50	–50
1993	\$200	\$100	–100
1994	\$300	\$500	+200

In 1994, you had unused foreign tax of \$200 to carry to other years. You are considered to have paid this unused foreign tax first in 1992 (the second preceding tax year) to the extent of the excess limit in that year of \$50, and then in 1993 (the first preceding tax year) to the extent of that year's excess limit of \$100. You can then carry forward the remaining \$50 of unused tax.

Example 2. All your foreign income is in the passive income category. In 1990, you had an unused foreign tax of \$200. Since you had no foreign income in 1988 and 1989, you cannot claim a credit for the unused foreign taxes

in those years. You can, however, carry forward the unused tax to 1991, 1992, 1993, 1994, and 1995. The limit on your credit and the qualified foreign taxes paid on passive income are as follows:

	Your limit	Tax Paid	Unused foreign tax (+) or excess limit (-)
1990	\$200	\$400	+200
1991	\$200	\$300	+100
1992	\$100	\$300	+200
1993	\$300	\$150	-150
1994	\$400	\$300	-100
1995	\$100	\$150	+50

You are not considered to have paid the \$200 of unused foreign tax from 1990 in 1991 or 1992 since you have no excess limit in either of those years. Therefore, you carry the tax forward and are considered to have paid it in 1993. The carryover reduces your excess limit in that year to zero. The remaining unused foreign tax of \$50 can be carried to 1994. At this point, you have fully absorbed the unused foreign tax from 1990 and can carry it no further. You can also carry forward the unused foreign tax from 1991 and 1992.

Effect of bankruptcy or insolvency. If your debts are canceled because of bankruptcy or insolvency, you may have to reduce your unused foreign tax carryovers to or from the tax year of the debt cancellation by 33% for each \$1 of canceled debt that you exclude from your gross income. This reduction may have to be made by your bankruptcy estate if it has acquired your unused foreign tax carryovers. You also may not be allowed to carry back any unused foreign tax to a year before the year in which the bankruptcy case began. For more information, see Publication 908, *Tax Information on Bankruptcy*.

Time Limit on Tax Assessment

When you carry back an unused foreign tax, the time limit for an IRS assessment of tax resulting from the carryback is extended. An assessment can be made up to the end of one year after the expiration of the statutory period for an assessment relating to the year in which the carryback originated.

Claim for Refund

If you have an unused foreign tax that you are carrying back to the first or the second preceding tax year, you should file Form 1040X, *Amended U.S. Individual Income Tax Return*, for each earlier tax year to which you are carrying the unused foreign tax, and attach a revised Form 1116.

Taxes All Credited or All Deducted

In a given year, you must either claim a credit for all foreign taxes that qualify for the credit or claim a deduction for all of them. This rule is applied with the carryover procedure, as follows:

- 1) You cannot claim a credit carryback or carryover from a year in which you deducted qualified foreign taxes,

- 2) You cannot deduct unused foreign taxes in any year to which you carry them, even if you deduct qualified foreign taxes actually paid in that year, and
- 3) You cannot claim a credit for unused foreign taxes in a year to which you carry them unless you also claim a credit for foreign taxes actually paid or accrued in that year.

If you claim a deduction instead of a credit for foreign taxes in a tax year, you must treat any unused foreign taxes that you could have carried to that year as if you had used them in that year in taking a credit to the extent of any applicable credit limit. In other words, if in an earlier year you had deducted foreign taxes paid or accrued instead of claiming a credit for them, you must treat the unused foreign taxes of the current year carried back to the **deduction year** as paid or accrued in the deduction year to the extent of any excess limit (as defined earlier) in that year. You cannot deduct or claim a credit for the unused foreign taxes carried to that year.

A **deduction year** is a year in which you choose not to claim the foreign tax credit, but in which there is an excess limit that would allow you to absorb some or all of an unused foreign tax if you claimed the credit. You may carry to a later year only the part of the carryback not treated as paid or accrued in the deduction year. Because you cannot deduct or claim a credit for the amount treated as paid or accrued in a deduction year, you will get no tax benefit for those taxes (the amount absorbed) unless you file a timely refund claim to reverse your choice from deducting the taxes to claiming the credit.

Example. In 1994, you paid foreign taxes of \$300 to Country X on income in the passive category. You have a foreign tax credit carryover of \$200 from the same category from 1993. For 1994, you figure your foreign tax credit limit to be \$400.

If you choose to claim a credit for your foreign taxes in 1994, you would be allowed a credit of \$400, consisting of \$300 paid in 1994 and \$100 of the \$200 carried over from 1993. You will have a credit carryover to 1995 of \$100, which is your unused 1993 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 1994, your deduction will be limited to \$300, which is the amount of taxes paid in 1994. You are not allowed a deduction for any part of the carryover from 1993. However, you must consider \$100 of the carryover credit used in 1994, because you have an unused credit limit of \$100 (\$400 minus the required reduction of \$300 to account for the deduction taken in lieu of the credit) that must be used to reduce your carryover to later years. Consequently, you can carry over only \$100 of the unused 1993 foreign tax credit to 1995.

If you claimed the deduction for 1994 and later decided you wanted to receive a benefit for that \$100 part of the 1993 carryover, you could reverse the choice of a deduction for 1994 and claim a credit for those taxes for that year by filing a claim for credit or refund within

the time allowed (see *Making or Changing Your Choice*, discussed earlier under *Choice To Take Credit or Deduction*).

Joint Return

For a tax year in which you and your spouse file a joint return, you must figure the unused foreign tax or excess limit in each separate limit category on the basis of your combined income, deductions, taxes, and credits.

Continuous use of joint return. If you and your spouse file a joint return for the current tax year, and file joint returns for **each** of the other tax years involved in figuring the carryback or carryover of unused foreign tax to the current tax year, you figure the joint carryback or carryover to the current tax year on the basis of the joint unused foreign tax and the joint excess limits.

From separate to joint return. If you and your spouse file a joint return for the current tax year, but file separate returns for all the other tax years involved in figuring the carryback or carryover of the unused foreign tax to the current tax year, your separate carrybacks or carryovers will be a joint carryback or carryover to the current tax year.

Allocations Between Husband and Wife

You may have to allocate an unused foreign tax or excess limit for a tax year in which you and your spouse filed a joint return. This allocation is needed in the following three situations:

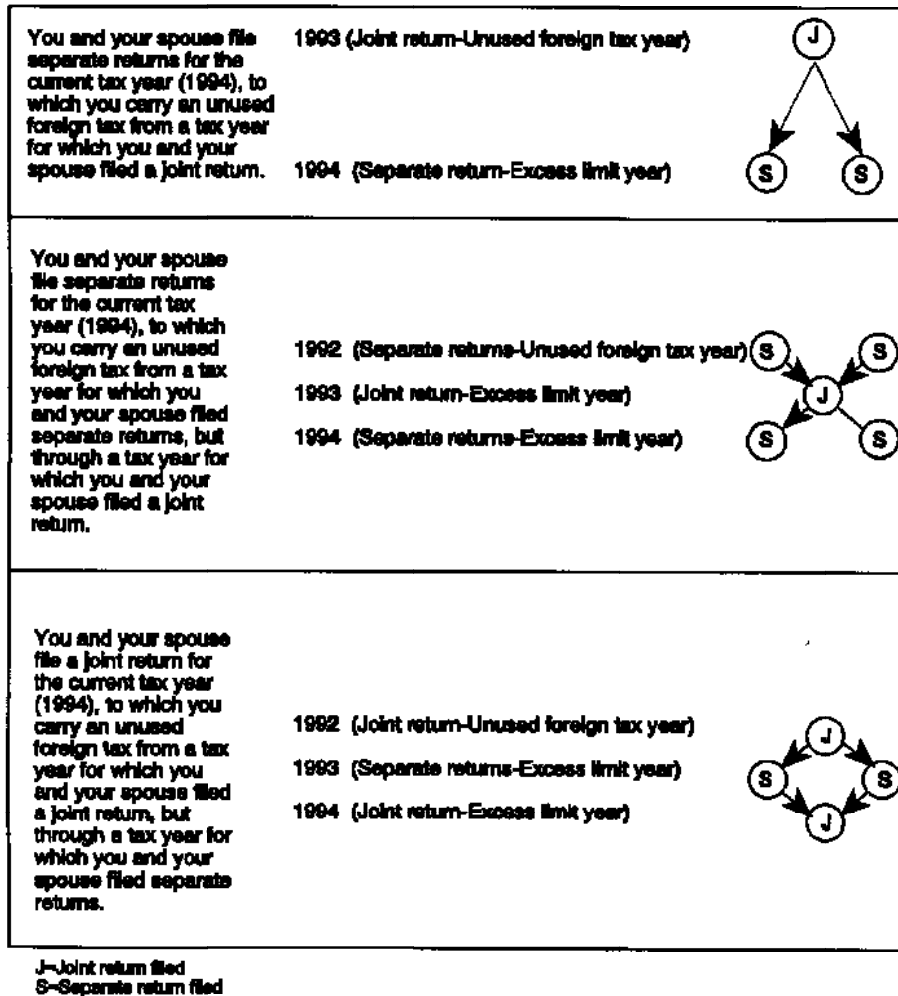
- 1) You and your spouse file separate returns for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return,
- 2) You and your spouse file separate returns for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed separate returns, but through a tax year for which you and your spouse filed a joint return, and
- 3) You and your spouse file a joint return for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return, but through a tax year for which you and your spouse filed separate returns.

These three situations are illustrated in **Figure A**. In each of the situations, 1994 is the current year.

Method of allocation. For a tax year in which you must allocate the unused foreign tax or the excess limit for your separate income categories between you and your spouse, you must take the following steps:

- 1) Figure the percentage that the taxable income of each spouse from sources outside the United States in each separate income category is to the joint taxable income from sources outside the United

Figure A. Allocation Between Husband and Wife



States in each category. Then, apply that percentage to its category's joint foreign tax credit limit to find the part of the limit allocated to each spouse.

- 2) Figure the part of the unused foreign tax, or of the excess limit, for each separate income category allocable to each spouse. You do this by comparing the allocated limit (figured in (1)), with the foreign taxes paid or accrued by each spouse on income in that category. If the foreign taxes you paid or accrued for that category are more than your part of its limit, you have an unused foreign tax. If, however, your part of that limit is more than the foreign taxes you paid or accrued, you have an excess limit for that category.

Allocation of the carryback and carryover. The mechanics of the carryback and carryover, when allocations between husband and wife are needed, are illustrated by the following example.

Example. A Husband (H) and Wife (W) filed joint returns for 1990, 1992, and 1993 and separate returns for 1991 and 1994. Neither H nor W had any unused foreign tax or excess

limit for any year before 1990. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are in the general limitation income category and are shown in Table 5.

W's allocated part of the unused foreign tax from 1990 (\$30) is partly absorbed by her separate excess limit of \$20 for 1991, and then fully absorbed by her allocated part of the joint excess limit for 1992 (\$20). H's allocated part of the unused foreign tax from 1990 (\$50) is fully absorbed by his allocated part of the joint excess limit (\$65) for 1992.

H's separate unused foreign tax from 1991 (\$25) is partly absorbed (to the extent of \$15) by his remaining excess limit in 1992, and then fully absorbed by W's remaining part of the joint excess limit for 1992 (\$10). Thus, each spouse's excess limit on a joint return (for 1992 in this case) is reduced in three ways. First, it is reduced by each one's carryover from earlier years (W has a carryover of unused foreign tax of \$10 from 1990). Second, it is reduced by any carryover or carryback from the year of origin of the unused foreign tax under consideration (in this example W had no carryover of unused foreign tax from 1991 but rather an excess limit). Third, it is reduced by

the unabsorbed carryover or carryback of the other spouse from the year of origin of the unused foreign tax (H's remaining \$10 of unused foreign tax carryover from 1991).

W's allocated part of the unused foreign tax of \$69 from 1993 is partly absorbed by her excess limit in 1994 (\$10), and the remaining \$59 will be a carryover to the general limitation income category for 1995 and the following 3 years unless absorbed sooner. H's allocated part of the unused foreign tax of \$104 from 1993 is partly absorbed by his excess limit in 1994 (\$50), and the remaining \$54 will be a carryover to 1995 and the following 3 years unless absorbed sooner.

Joint Return Filed in a Deduction Year

When you file a joint return in a deduction year, and carry unused foreign tax through that year from the prior year in which you and your spouse filed separate returns, the amount absorbed in the deduction year is the unused foreign tax of each spouse deemed paid or accrued in the deduction year to the extent of that spouse's excess limit in that year. You cannot reduce either spouse's excess limit in the deduction year by the other's unused foreign taxes in that year.

Tax Treaties

The tax treaties to which the United States is a party are designed, in part, to prevent double taxation of the same income by the United States and the treaty country. Certain treaties have special rules you must consider when figuring your foreign tax credit if you are a U.S. citizen residing in the treaty country. These provisions generally allow an additional credit for part of the tax imposed by the treaty partner on U.S. source income. It is separate from, and in addition to, your foreign tax credit for foreign taxes paid or accrued on foreign source income. The treaties that provide for this special credit are those with **France, Canada, Italy, Australia, New Zealand, Finland, India, Spain, Germany, Tunisia, Barbados, Czech Republic, Slovak Republic, Mexico, and the Netherlands**. There is a worksheet at the end of this publication to help you figure the special credit. For more information, write to the Internal Revenue Service, Assistant Commissioner (International), Attention: CP:IN:C:TPS, 950 L'Enfant Plaza South, S.W., Washington, DC 20024.

You can also contact the United States Revenue Service Representatives at the U.S. Embassies in Paris, Ottawa, Rome, Sydney, London, Singapore, Bonn, Caracas, Mexico City, and S'ao Paulo, as appropriate, for assistance.

How To Claim the Credit

You must file Form 1116 to claim a credit for foreign taxes. You are also required to translate your foreign income and taxes into U.S. dollars.

Table 5. Carryback/Carryover

Tax Year	1990	1991	1992	1993	1994
Return	Joint	Separate	Joint	Joint	Separate
H's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses)	\$50	\$25	(\$65)	\$104	(\$50)
W's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses)	\$30	(\$20)	(\$20)	\$69	(\$10)
Carryover absorbed:					
W's from 1990	—	20W	10W	—	—
H's from 1990	—	—	50H	—	—
H's from 1991	—	—	15H	—	—
"	—	—	10W	—	—
W's from 1993	—	—	—	—	10W
H's from 1993	—	—	—	—	50H
W=Absorbed by W's excess limit					
H=Absorbed by H's excess limit					

*General limitation income category only

Form 1116

If you claim the foreign tax credit, you must file a Form 1116, *Foreign Tax Credit*, with your U.S. income tax return, Form 1040. You should keep a receipt for each foreign tax payment if you claim a credit in the year you paid foreign taxes. If you claim a credit for taxes accrued, keep the foreign tax return on which you based the accrued tax. Amounts you report on Form 1116 should be in U.S. dollars except where indicated in columns (n), (o), (p), and (q) of Part II.

Although you are not required to attach proof of the foreign taxes paid or accrued to your Form 1116, you should keep this proof in case you are later asked to verify the taxes shown on your Form 1116.

The receipt or return you keep as proof should be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. If the receipt or return is in a foreign language, you also should provide a certified translation of it. Revenue Ruling 67-308, 1967-2 C.B. 254, discusses, in detail, the requirements of the certified translation. You can buy the *Cumulative Bulletin* from the Government Printing Office. Copies of the *Cumulative Bulletins* are also available in most IRS offices and you are welcome to read them there.

The purpose of Form 1116 is to help you figure the amount of foreign taxes paid or accrued that you may claim as a foreign tax credit. The Internal Revenue Service Center will not compute your credit for you on Form 1116, even if provided with the necessary information.

You must file a separate Form 1116 for each of the following types of income for which you claim a foreign tax credit:

- 1) Passive income,
- 2) High withholding tax interest,
- 3) Financial services income,
- 4) Shipping income,
- 5) Dividends from a DISC or former DISC,
- 6) Certain distributions from a FSC or former FSC,

- 7) Lump-sum distributions, and
- 8) General limitation income—all other income from sources outside the United States.

A Form 1116 consists of four parts as explained here:

- 1) **Part I—Taxable Income or Loss From Sources Outside the United States for Separate Category Checked Above.** Enter the gross amounts of your foreign or possession source income in the separate limit category for which you are completing the form. From these, subtract the deductions that are definitely allocable and apportioned to the separate limit income, and a ratable share of the deductions not definitely allocable to that income. If, in a separate limit category, you received income from more than one foreign country or U.S. possession, complete a separate column for each. **Note:** if you receive only passive income and your foreign tax paid or accrued is \$200 or less (\$400 if married filing jointly), you may not have to list each country separately. See the instructions for Form 1116 for more information.
- 2) **Part II—Foreign Taxes Paid or Accrued.** You must complete all applicable lines of this part. This part shows the foreign taxes you paid or accrued on the income in the separate limit category in foreign currency and U.S. dollars. If you paid (or accrued) foreign tax to more than one foreign country or U.S. possession, complete a separate line for each.
- 3) **Part III—Figuring the Credit.** You use this part to figure the foreign tax credit that is allowable.
- 4) **Part IV—Summary of Credits From Separate Parts III.** You use this part on one Form 1116 to summarize the foreign tax credits figured on separate Forms 1116. You also determine your foreign tax credit allowable for the year by subtracting the

foreign tax credit attributable to an international boycott from the otherwise allowable foreign tax credit.

Alternative Minimum Tax

In addition to your regular income tax, you may be liable for the alternative minimum tax. The foreign tax credit is allowed to a limited extent against this tax. See the instructions for Form 6251, *Alternative Minimum Tax—Individuals*, for a discussion of the alternative minimum tax and the foreign tax credit applied against it.

Foreign Currency and Exchange Rates

The U.S. income tax is imposed on income expressed in U.S. dollars, while the foreign tax is imposed on income expressed in foreign currency. Therefore, the tax credit is affected when the foreign currency depreciates or appreciates in value in terms of U.S. dollars.

Rate of exchange for foreign income. When reporting foreign income on your U.S. income tax return, you are required to report income and expenses in your functional currency.

The U.S. dollar is the functional currency for all taxpayers except some qualified business units. A qualified business unit is a separate and clearly identified unit of a trade or business that maintains separate books and records. Therefore, unless you are self-employed, your functional currency is the U.S. dollar.

Even if you are self-employed and have a qualified business unit, your functional currency is the dollar if any of the following apply:

You conduct the business in dollars.

The principal place of business is located in the United States.

You choose to or are required to use the dollar as your functional currency.

The business books and records are not kept in the currency of the economic environment in which a significant part of the business activities is conducted.

You translate the value of foreign currency into U.S. dollars at the rates of exchange prevailing at the time you actually or constructively received the income or paid the expenses. You should use the rate that most nearly reflects the value of foreign currency—the official rate, the open market rate, or any other appropriate rate. You must be able to justify the rate you use. You can generally get exchange rates from banks and U.S. Embassies.

If you are self-employed in a foreign country, you may have to report income and expenses for that business in foreign currency. For more information, write to the Internal Revenue Service, Assistant Commissioner (International), Attention: CP:IN:C:TPS, 950 L'Enfant Plaza South, S.W., Washington, DC 20024.

Rate of exchange for foreign taxes paid. If you claim the credit for foreign taxes on the cash basis, use the rate of exchange in effect on the date of payment of foreign taxes to the foreign country. If your tax was withheld in foreign currency, you use the rate of exchange in effect for the date on which the tax is withheld. If you make foreign estimated tax payments, you use the rate of exchange in effect for the date on which the estimated payment is made.

If you claim the credit for foreign taxes on an accrual basis, you should use the rate of exchange in effect on the last day of your tax year in converting the foreign money into U.S. dollars. This is a provisional or interim credit. If a different rate of exchange is in effect when you actually pay the tax, you must make an adjustment to reflect that rate. See *Adjustments under Credit for Taxes Paid or Accrued*, earlier.

International Boycott

If you participate in or cooperate with an international boycott during the tax year, your foreign tax credit otherwise allowable or foreign taxes available for credit in the applicable separate income category may be reduced.

Other benefits related to an interest charge domestic international sales corporation (IC-DISC), a controlled foreign corporation (CFC), and a foreign sales corporation (FSC) may be denied.

These rules generally do not apply to employees with wages who are working and living in a boycotting country, or to retirees with pensions who are living in these countries.

List of boycotting countries. A list of the countries which may require participation in or cooperation with an international boycott is published by the Department of the Treasury at the beginning of each calendar quarter. As of the revision date of this publication, the following countries are listed:

Table 6. Boycotting Countries

Bahrain	Oman
Iraq	Qatar
Jordan	Saudi Arabia
Kuwait	Syria
Lebanon	United Arab Emirates
Libya	Republic of Yemen

For information concerning changes to the list, write to the Internal Revenue Service, Assistant Commissioner (International), Attention: CP:IN:C:TPS, 950 L'Enfant Plaza South, S.W., Washington, DC 20024.

Determinations of Particular Operations

You may request a determination from the Internal Revenue Service as to whether a particular operation constitutes participation

in or cooperation with an international boycott. The procedures for obtaining a determination from the Service are outlined in Revenue Procedure 77-9, 1977-1 C.B. 542. You can buy the *Cumulative Bulletin* from the Government Printing Office. Copies are also available in most IRS offices and you are welcome to read them there.

Public inspection. A determination is treated as a written determination and is open to public inspection. In addition, any background file related to the determination is open to public inspection. However, your identity and certain other information will remain confidential.

Reporting Requirements

If you are a **U.S. person** (defined later), you must file a report if you:

- 1) Have operations,
- 2) Are a member of a controlled group, a member of which has operations,
- 3) Are a U.S. shareholder who owns 10% or more of the voting power of all voting stock of a foreign corporation that has operations, but only if you own the stock of the foreign corporation directly or through foreign entities,
- 4) Are a partner in a partnership that has operations, or
- 5) Are treated as the owner of a trust that has operations

in or related to a boycotting country (or with the government, a company, or national of a boycotting country).

A U.S. person is a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust which does not exclude from income its foreign source income that is not effectively connected with the conduct of a trade or business within the United States.

Form required. If you are required to file a report, you must use Form 5713, *International Boycott Report*, and attach all applicable supporting schedules and forms contained in your income tax returns that indicate the amount and how you figured the benefits denied.

You must file the form in duplicate when your tax return is due, including extensions. You should send one copy to the Internal Revenue Service Center, Philadelphia, PA 19255. You should attach the other copy to your income tax return which you file with your usual Internal Revenue Service Center.

Failure to file. If you willfully fail to make a report, in addition to other penalties, you may be fined not more than \$25,000 or imprisoned for no more than one year, or both.

Confidentiality of reports. Your reports submitted as part of the tax return are confidential.

Simple Example—filled in Form 1116

Betsy Wilson is a U.S. citizen who owns 200 shares of XYZ company, a German corporation. She received a dividend of \$620 from XYZ, which withheld and paid tax of \$93 to Germany for her dividend of \$620. Betsy will need to complete a Form 1116 to claim the \$93 as a credit. Betsy, who is single and under 65, works as a night auditor and earns \$21,000.

To complete Form 1116 Betsy fills in her name, social security number, and checks the box for passive income. In Part I of the form she writes the name of the foreign country in column A and shows on line 1 the amount of income (\$620) she received from XYZ company. Next, since Betsy does not itemize her deductions, she puts her standard deduction (\$3,800) on line 3a and completes 3b and 3c. Her total foreign source income (line 3d) is \$620 and gross income from all sources (line 3e) is \$21,620. She completes this section for a result of \$109 for line 6. Line 7 is \$511, the difference between lines 1 and 6.

In Part II Betsy completes the form through line 8. This is the amount of tax XYZ paid in Germany.

In Part III Betsy figures her credit as shown on the completed form. The computation shows that she may take part of the amount paid to Germany as a credit against her U.S. income tax. Because this is the only Form 1116 that Betsy must complete, she does not need to fill in lines 22 through 29 of Part IV. The balance of the foreign tax paid to Germany is available for a carryback and/or carryover.

Comprehensive Example — Filled-In Form 1116

Robert Smith, a U.S. citizen, is a salesman who worked in Country X for all of 1994, except for one week he spent in the United States on business. He is single and under 65. He is a cash-basis taxpayer who uses the calendar year as his tax year.

During 1994, Robert received income from sources within Country X and the United States. Robert received \$2,400 wages for services performed during the one week in the United States. He also received \$3,000 dividend income from sources within the United States.

Income from Country X. Robert received the following income from Country X during the year and paid tax on the income to Country X on December 31, 1994. The conversion rate throughout 1994 was 2 pesos to each U.S. dollar (2:1).

Income	Tax
\$100,000 wages (200,000 pesos @2:1)	\$27,400 (54,800 pesos @2:1)
\$4,000 dividend income (8,000 pesos @2:1)	\$600 (1,200 pesos @2:1)
\$1,000 interest income (2,000 pesos @2:1)	\$50 (100 pesos @2:1)

Foreign earned income. Robert meets the physical presence test and figures his allowable exclusion of foreign earned income on Form 2555, *Foreign Earned Income* (not illustrated). He excludes \$70,000 of the wages earned in Country X.

Business expenses. Robert paid \$3,400 of unreimbursed business expenses, which were attributable to the wages he earned in Country X. Robert must prorate the business expenses between the wages he includes on his U.S. tax return and the amount he excludes as foreign earned income. He cannot deduct the part of the expenses attributable to the income that he excludes. He figures his allowable expenses as follows:

$$\frac{\$30,000}{\$100,000} \times \$3,400 = \$1,020$$

He claims his expenses of \$1,020 as an itemized deduction on Schedule A (Form 1040), subject to the 2% of adjusted gross income limit. The balance, \$2,380 (\$3,400 – \$1,020), is attributable to the excluded income and not deductible.

Itemized deductions. For 1994, Robert was entitled to the following itemized deductions.

Interest on home mortgage	\$2,900
Real estate tax	940
Washington Church	460
Employee expenses [\$1,020 – \$808 (\$40,400×2%)]	212
Total	<u>\$4,512</u>

Forms 1116

Robert must use two Forms 1116 to figure his allowable foreign tax credit. On one Form 1116, he will mark the block—*General limitation income—all other income from sources outside the United States*, and figure his foreign tax credit on the wages of \$100,000. On the other Form 1116, he will mark the block—*Passive income*, and figure his foreign tax credit on his interest income of \$1,000 and dividend income of \$4,000.

Under the discussion, later, for each part on the Form 1116, Robert's computations are explained for *each* Form 1116 that must be completed. Both Forms 1116 are illustrated at the end of this publication.

Computation of Taxable Income

Before making any entries on Form 1116, Robert must figure his taxable income on Form 1040.

His taxable income is \$33,438, figured as follows:

Gross Income	
Wages (Country X)	\$100,000
Less: Foreign earned income exclusion	70,000
	<u>\$ 30,000</u>
Wages (U.S.)	2,400
Interest income (Country X)	1,000
Dividend income (U.S.)	3,000
Dividend income (Country X)	4,000
Total (Adjusted gross income)	<u>\$ 40,400</u>
Less: Total Itemized Deductions	
Total itemized deductions	<u>4,512</u>
Taxable income before the personal exemption	\$ 35,888
Less: Personal Exemption	<u>2,450</u>
Taxable Income	<u>\$ 33,438</u>

On each Form 1116, Robert enters \$35,888 (his taxable income *before* the personal exemption) on line 17 of Part III.

Part I—Taxable Income or Loss From Sources Outside the United States for Separate Category Checked Above

In figuring the limit on both Forms 1116, Robert must separately determine his taxable income from Country X.

To figure his taxable income, Robert first reduces gross income from sources within Country X by expenses and other deductions that are definitely allocable to the income, and next by a ratable share of all other deductions that are not definitely allocable to specific income sources. Robert figures the ratable share of deductions not definitely allocable by using the ratio of gross income from sources within Country X to gross income from all sources. Since Robert itemizes his deductions, he does not consider the standard deduction in his allocation.

Form 1116—General limitation income—all other income from sources outside the United States. On this Form 1116, Robert figures his taxable income from Country X for income in the general limitation income category only. He does not include his passive income of interest and dividends.

Robert enters the wages earned in Country X of \$30,000 (after subtracting the foreign earned income exclusion) on line 1.

Since the unreimbursed business expenses, \$3,400, are allocable to the full \$100,000 of wages earned in Country X, Robert must prorate the expenses between those attributable to included wages and those attributable to wages excluded as foreign earned income. He enters the part of the expenses, \$212 (after the 2% of adjusted gross income limit), attributable to included wages as definitely allocable expenses on line 2. He attaches this explanation (not illustrated) to his Form 1116.

The qualified home mortgage interest, \$2,900, is allocable to all gross income. Robert apportions this interest to general limitation income as follows:

$$\frac{\$30,000}{\$40,400} \times \$2,900 = \$2,153$$

For this purpose, gross income does not include the wages that qualified for the foreign earned income exclusion. Robert enters this amount, \$2,153, on line 4a.

Robert must prorate the balance of his itemized deductions, \$1,400 (line 3a) that are not definitely allocable to income from any source, by using the ratio of gross income from Country X in the general limitation category (line 3d) to his gross income from all sources (line 3e). For this purpose, gross income from Country X and gross income from all sources includes the \$70,000 of wages that qualify for the foreign earned income exclusion. He figures the ratable part of deductions, \$1,268, as follows and enters it on line 3g.

$$\frac{\$100,000}{\$110,400} \times \$1,400 = \$1,268$$

Robert subtracts the prorated definitely allocable expenses and the prorated interest expense and other itemized deductions from gross foreign source income in the general limitation income category to arrive at foreign source taxable income of \$26,367 in that category. Robert enters this amount on line 7.

Form 1116—Passive income. On this Form 1116, Robert determines the taxable income from Country X for passive interest and dividend income. He enters the \$1,000 interest income and the \$4,000 dividend income from Country X on line 1.

Robert apportions the qualified residence interest to passive income as follows:

$$\frac{\$5,000}{\$40,400} \times \$2,900 = \$359$$

He enters this amount, \$359, on line 4a.

Robert figures the ratable part of the balance of his itemized deductions allocable to passive income as follows and enters the amount on line 3g.

$$\frac{\$5,000}{\$110,400} \times \$1,400 = \$63$$

Robert subtracts the amounts on lines 4a and 3g from passive gross foreign source income to arrive at passive foreign source taxable income of \$4,578. Robert enters this amount on line 7.

Part II—Foreign Taxes Paid or Accrued

Robert uses Part II, Form 1116, to report the foreign tax paid or accrued on income from foreign sources.

Form 1116—General limitation income—all other income from sources outside the United States. On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on the wages from Country X.

Form 1116—Passive income. On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on the interest and dividend income.

Part III—Figuring the Credit

Robert figures the amount of foreign tax credit in Part III on each Form 1116.

Form 1116—General limitation income—all other income from sources outside the United States. Robert figures the amount of foreign tax credit allowable for the foreign taxes paid on his wages from Country X. He has a carryover of \$200 for unused foreign taxes paid in 1993 and enters that amount on line 10. He attaches a schedule showing how he figured his \$200 carryover to 1994 after carrying back the unused \$350 tax paid in 1993 to the 2 preceding tax years. (See *Schedule Showing Computation of Carryover (Table 7)*). The unused foreign tax in 1993 and the excess limits in 1991 and 1992 are in the general limitation income category. The amount of \$200 is carried over to the general limitation income category in 1994.

On line 12, Robert must reduce the total foreign taxes paid by the amount allocable to the wages he excludes as foreign earned income. To do this, he multiplies the \$27,400 foreign tax he paid on his foreign wages by a fraction. The numerator of the fraction is his foreign earned income exclusion (\$70,000) minus a proportionate part of his directly allocable business expenses (\$2,380), and the denominator of the fraction is his total foreign wages (\$100,000) minus his total directly allocable business expenses (\$3,400). He enters the result, \$19,180, on line 12. His total foreign taxes available for credit are \$8,420 (\$200 + \$27,400 – \$19,180).

Robert figures the ratio of the taxable income from sources outside the United States

in the general limitation income category to taxable income from all sources as follows and enters it on line 18.

$$\$26,367 \div \$35,888 = .7347$$

Robert finds his U.S. tax liability before any credits using the column in the Tax Table for single individuals. His tax from the table is \$6,402.

Robert then multiplies the U.S. tax liability by the limit ratio (.7347) and determines the limit as follows:

$$\$6,402 \times .7347 = \$4,704$$

The foreign tax credit is the lesser of the foreign tax available for credit, \$8,420, or the limit, \$4,704.

Form 1116—Passive income. Robert now figures the foreign tax credit allowable on the foreign source taxable income (total of interest and dividend income minus applicable deductions).

He figures the ratio of foreign source taxable income to taxable income from all sources as follows and enters it on line 18.

$$\$4,578 \div \$35,888 = .1276$$

Robert multiplies his U.S. tax liability by the limit ratio and determines the limit as follows:

$$\$6,402 \times .1276 = \$817$$

The foreign tax credit is the lesser of the foreign tax paid, \$650, or the limit, \$817.

Part IV—Summary of Credits From Separate Parts III

Robert summarizes his foreign tax credits for the two types of income on Part IV of **one**

Form 1116. He uses the Part IV of Form 1116—**General limitation income—all other income from sources outside the United States**.

Robert did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is, therefore, \$5,354 (\$650 + \$4,704), shown on line 32. He also enters this amount on line 43 of Form 1040.

Unused Foreign Taxes

Robert now figures if he has any unused foreign taxes that can be used as a carryback or carryover to other tax years.

General limitation income—all other income from sources outside the United States. Robert has 1994 unused foreign taxes of \$3,716 (\$8,420 – \$4,704) available as a carryover to 1995 and later years. (The foreign taxes attributable to his foreign earned income exclusion are not available for carryover.) He cannot carry back any part of the 1994 unused taxes to 1992 or 1993 as shown in the *Schedule Showing Computation of Carryover (Table 7)*.

Passive income. Since the tax Robert paid on his interest and dividend income is less than the amount for which he could have claimed a credit in 1994 under the limit for this separate income category, he has no unused tax and therefore no carryback or carryover to other tax years.

Form **1116**Department of the Treasury
Internal Revenue Service**Foreign Tax Credit**

(Individual, Fiduciary, or Nonresident Alien Individual)

► Attach to Form 1040, 1040NR, 1041, or 990-T.

► See separate instructions.

OMB No. 1545-0121

1994Attachment
Sequence No. **19**

Name

Betsy Wilson

Identifying number as shown on page 1 of your tax return

111-00-1111

Report all amounts in U.S. dollars except where specified in Part II. Use a separate Form 1116 for each category of income listed below. Check only one box. Before you check a box, read *Categories of Income* on page 3 of the instructions. Complete this form for credit for taxes on:

- ☒ **a** Passive income ☐ **d** Shipping income ☐ **g** Lump-sum distributions (see instructions before completing form)
☐ **b** High withholding tax interest ☐ **e** Dividends from a DISC or former DISC ☐ **h** General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)
☐ **c** Financial services income ☐ **f** Certain distributions from a foreign sales corporation (FSC) or former FSC

i Resident of (name of country) ► Germany

Note: If you paid taxes to one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under *How To Complete Form 1116* on page 1 of the instructions.

Part I Taxable Income or Loss From Sources Outside the United States for Separate Category Checked Above

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
1 Enter the name of the foreign country or U.S. possession ► <u>Germany</u>				
1 Gross income from sources within country shown above and of the type checked above. See instructions:				
	<u>620</u>			<u>620</u>
Applicable deductions and losses. (See instructions.):				
2 Expenses directly allocable to the income on line 1 (attach schedule)				
3 Pro rata share of other deductions not directly allocable:				
a Certain itemized deductions or standard deduction. See instructions	<u>3,800</u>			
b Other deductions (attach schedule)	<u>3,800</u>			
c Add lines 3a and 3b	<u>620</u>			
d Gross foreign source income. See instructions	<u>21,620</u>			
e Gross income from all sources. See instructions	<u>22,240</u>			
f Divide line 3d by line 3e	<u>.0287</u>			
g Multiply line 3c by line 3f	<u>109</u>			
4 Pro rata share of interest expense. See instructions:				
a Home mortgage interest from line 5 of the worksheet on page 8 of the instructions				
b Other interest expense				
5 Losses from foreign sources.				
6 Add lines 2, 3g, 4a, 4b, and 5	<u>109</u>			<u>109</u>
7 Subtract line 6 from line 1. Enter the result here and on line 14. ►				<u>511</u>

Part II Foreign Taxes Paid or Accrued (See instructions.)

Country	Credit is claimed for taxes (you must check one) (u) <input checked="" type="checkbox"/> Paid (v) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued						(v) Total foreign taxes paid or accrued (add cols. (r) through (u))			
		In foreign currency			In U.S. dollars						
		Taxes withheld at source on:			Taxes withheld at source on:						
		(w) Date paid or accrued	(n) Dividends	(o) Rents and royalties	(p) Interest	(q) Other foreign taxes paid or accrued	(r) Dividends	(s) Rents and royalties	(t) Interest		
A		<u>12-31-94</u>	<u>145</u>				<u>93</u>				<u>93</u>
B											
C											
8 Add lines A through C, column (v). Enter the total here and on line 9. ►										<u>93</u>	

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Cat. No. 11440U

Form 1116 (1994)

Part III Figuring the Credit

9	Enter amount from line 8. This is the total foreign taxes paid or accrued for the category of income checked above Part I	9	93	
10	Carryback or carryover (attach detailed computation)	10	0	
11	Add lines 9 and 10	11	93	
12	Reduction in foreign taxes. See instructions	12	0	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit	13	93	
14	Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See instructions	14	511	
15	Adjustments to line 14. See instructions	15	0	
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.)	16	511	
17	Individuals: Enter amount from Form 1040, line 35. If you are a nonresident alien, enter amount from Form 1040NR, line 34. Estates and trusts: Enter your taxable income without the deduction for your exemption <i>Caution: If you figured your tax using the maximum tax rate on capital gains, see instructions.</i>	17	17,820	
18	Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1"	18	.0287	
19	Individuals: Enter amount from Form 1040, line 40, less any amounts on Form 1040, lines 41, 42, and any mortgage interest credit (from Form 8396) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 39, less any amount on Form 1040NR, line 40 and any mortgage interest credit (from Form 8396) on line 42. Estates and trusts: Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37	19	2,306	
20	Multiply line 19 by line 18 (maximum amount of credit)	20	66	
21	Enter the amount from line 13 or line 20, whichever is smaller. (If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate lines in Part IV.)	21	66	

Part IV Summary of Credits From Separate Parts III (See instructions.)

22	Credit for taxes on passive income	22		
23	Credit for taxes on high withholding tax interest	23		
24	Credit for taxes on financial services income	24		
25	Credit for taxes on shipping income	25		
26	Credit for taxes on dividends from a DISC or former DISC	26		
27	Credit for taxes on certain distributions from a FSC or former FSC	27		
28	Credit for taxes on lump-sum distributions	28		
29	Credit for taxes on general limitation income (all other income from sources outside the United States)	29		
30	Add lines 22 through 29.	30	66	
31	Reduction of credit for international boycott operations. See instructions for line 12.	31		
32	Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 38a.	32	66	

Table 7. Schedule Showing Computation of Carryover

	1991	1992	1993
Maximum credit allowable under limit....	\$450	\$700	\$1,200
Foreign tax paid in tax year.....	<u>400</u>	<u>600</u>	<u>1,550</u>
Unused foreign tax (+) to be carried over or excess of limit (–) over tax	–\$50	–\$100	+\$350
Tax credit carried back from 1993.....	<u>50</u>	<u>100</u>	
Net excess tax to be carried over to 1994	<u><u>0</u></u>	<u><u>0</u></u>	+\$350
Less: Carrybacks to 1991 and 1992			<u>150</u>
Amount carried over to 1994			<u><u>\$200</u></u>

Foreign Tax Credit
(Individual, Fiduciary, or Nonresident Alien Individual)

► Attach to Form 1040, 1040NR, 1041, or 990-T.

► See separate instructions.

1994Attachment
Sequence No. **19**

Name

Robert Smith

Identifying number as shown on page 1 of your tax return

000-00-0000

Report all amounts in U.S. dollars except where specified in Part II. Use a separate Form 1116 for each category of income listed below. Check only one box. Before you check a box, read Categories of Income on page 3 of the instructions. Complete this form for credit for taxes on:

- ☐ a Passive income ☐ d Shipping income ☐ g Lump-sum distributions (see instructions before completing form)
☐ b High withholding tax interest ☐ e Dividends from a DISC or former DISC
☐ c Financial services income ☐ f Certain distributions from a foreign sales corporation (FSC) or former FSC ☒ h General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)

i Resident of (name of country) ► **Country X**

Note: If you paid taxes to one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under How To Complete Form 1116 on page 1 of the instructions.

Part I Taxable Income or Loss From Sources Outside the United States for Separate Category Checked Above

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
1 Enter the name of the foreign country or U.S. possession ►	Country X			
1 Gross income from sources within country shown above and of the type checked above. See instructions:	30,000			30,000
Applicable deductions and losses. (See instructions.):				
2 Expenses directly allocable to the income on line 1 (attach schedule)	212			
3 Pro rata share of other deductions not directly allocable:				
a Certain itemized deductions or standard deduction. See instructions	1,400			
b Other deductions (attach schedule)	1,400			
c Add lines 3a and 3b	100,000			
d Gross foreign source income. See instructions	110,400			
e Gross income from all sources. See instructions	19,058			
f Divide line 3d by line 3e	1,258			
g Multiply line 3c by line 3f.				
4 Pro rata share of interest expense. See instructions:				
a Home mortgage interest from line 5 of the worksheet on page 6 of the instructions	2,153			
b Other interest expense				
5 Losses from foreign sources.				
6 Add lines 2, 3g, 4a, 4b, and 5	3,633			3,633
7 Subtract line 6 from line 1. Enter the result here and on line 14. ►				26,367

Part II Foreign Taxes Paid or Accrued (See instructions.)

Country	Credit is claimed for taxes (you must check one) (i) <input checked="" type="checkbox"/> Paid (ii) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued						(v) Total foreign taxes paid or accrued (add cols. (r) through (u))			
		In foreign currency			In U.S. dollars						
		Taxes withheld at source on:			Taxes withheld at source on:						
		(vi) Date paid or accrued	(vii) Dividends	(viii) Rents and royalties	(ix) Interest	(x) Other foreign taxes paid or accrued	(xi) Dividends	(xii) Rents and royalties	(xiii) Interest		
A		12-31-94				54,800				27,400	27,400
B											
C											

8 Add lines A through C, column (v). Enter the total here and on line 9. ►

27,400

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Cat. No. 11440U

Form **1116** (1994)

Part III Figuring the Credit

9	Enter amount from line 8. This is the total foreign taxes paid or accrued for the category of income checked above Part I.	8	27,400	
10	Carryback or carryover (attach detailed computation)	10	200	
11	Add lines 9 and 10	11	27,600	
12	Reduction in foreign taxes. See instructions	12	19,180	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit	13		8,420
14	Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See instructions	14	26,367	
15	Adjustments to line 14. See instructions	15	0	
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.)	16	26,367	
17	Individuals: Enter amount from Form 1040, line 35. If you are a nonresident alien, enter amount from Form 1040NR, line 34. Estates and trusts: Enter your taxable income without the deduction for your exemption <i>Caution: If you figured your tax using the maximum tax rate on capital gains, see instructions.</i>	17	35,888	
18	Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1"	18		.7347
19	Individuals: Enter amount from Form 1040, line 40, less any amounts on Form 1040, lines 41, 42, and any mortgage interest credit (from Form 8396) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 39, less any amount on Form 1040NR, line 40 and any mortgage interest credit (from Form 8396) on line 42. Estates and trusts: Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37.	19		6,402
20	Multiply line 19 by line 18 (maximum amount of credit)	20		4,704
21	Enter the amount from line 13 or line 20, whichever is smaller. (If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate lines in Part IV.)	21		4,704

Part IV Summary of Credits From Separate Parts III (See instructions.)

22	Credit for taxes on passive income	22	650	
23	Credit for taxes on high withholding tax interest	23		
24	Credit for taxes on financial services income	24		
25	Credit for taxes on shipping income	25		
26	Credit for taxes on dividends from a DISC or former DISC	26		
27	Credit for taxes on certain distributions from a FSC or former FSC	27		
28	Credit for taxes on lump-sum distributions	28		
29	Credit for taxes on general limitation income (all other income from sources outside the United States)	29	4,704	
30	Add lines 22 through 29.	30		5,354
31	Reduction of credit for international boycott operations. See instructions for line 12.	31		
32	Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 38a.	32		5,354



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Foreign Tax Credit
(Individual, Fiduciary, or Nonresident Alien Individual)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

1994Attachment
Sequence No. **19**

Name

Robert Smith

Identifying number as shown on page 1 of your tax return

000-00-0000

Report all amounts in U.S. dollars except where specified in Part II. Use a separate Form 1116 for each category of income listed below. Check only one box. Before you check a box, read **Categories of Income** on page 3 of the instructions. Complete this form for credit for taxes on:

- ☒ **a** Passive income ☐ **d** Shipping income ☐ **g** Lump-sum distributions (see instructions before completing form)
☐ **b** High withholding tax interest ☐ **e** Dividends from a DISC or former DISC
☐ **c** Financial services income ☐ **f** Certain distributions from a foreign sales corporation (FSC) or former FSC ☐ **h** General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)

i Resident of (name of country) ▶ Country X

Note: If you paid taxes to one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under **How To Complete Form 1116** on page 1 of the instructions.

Part I Taxable Income or Loss From Sources Outside the United States for Separate Category Checked Above

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
j Enter the name of the foreign country or U.S. possession ▶ <u>Country X</u>				
1 Gross income from sources within country shown above and of the type checked above. See instructions:	<u>5,000</u>			<u>5,000</u>
Applicable deductions and losses. (See instructions.):				
2 Expenses directly allocable to the income on line 1 (attach schedule)				
3 Pro rata share of other deductions not directly allocable:				
a Certain itemized deductions or standard deduction. See instructions	<u>1,400</u>			
b Other deductions (attach schedule)	<u>1,400</u>			
c Add lines 3a and 3b	<u>5,000</u>			
d Gross foreign source income. See instructions	<u>110,400</u>			
e Gross income from all sources. See instructions	<u>20453</u>			
f Divide line 3d by line 3e	<u>63</u>			
g Multiply line 3c by line 3f				
4 Pro rata share of interest expense. See instructions:				
a Home mortgage interest from line 5 of the worksheet on page 6 of the instructions	<u>359</u>			
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5	<u>422</u>			<u>422</u>
7 Subtract line 6 from line 1. Enter the result here and on line 14. ▶				<u>4578</u>

Part II Foreign Taxes Paid or Accrued (See instructions.)

Country	Credit is claimed for taxes (you must check one) (k) <input checked="" type="checkbox"/> Paid (l) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued						(v) Total foreign taxes paid or accrued (add cols. (r) through (u))	
		In foreign currency				In U.S. dollars			
		Taxes withheld at source on:				Taxes withheld at source on:			
		(m) Date paid or accrued	(n) Dividends	(o) Rents and royalties	(p) Interest	(q) Dividends	(s) Rents and royalties	(t) Interest	
A		<u>12-31-94</u>	<u>1,200</u>		<u>100</u>	<u>600</u>		<u>50</u>	<u>650</u>
B									
C									
8		Add lines A through C, column (v). Enter the total here and on line 9. ▶							<u>650</u>

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Cat. No. 11440U

Form **1116** (1994)

Part III Figuring the Credit

9	Enter amount from line 8. This is the total foreign taxes paid or accrued for the category of income checked above Part I.	9	650	
10	Carryback or carryover (attach detailed computation)	10		
11	Add lines 9 and 10	11	650	
12	Reduction in foreign taxes. See instructions	12	0	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit	13		650
14	Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See instructions	14	4,578	
15	Adjustments to line 14. See instructions	15	0	
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.)	16	4,578	
17	Individuals: Enter amount from Form 1040, line 35. If you are a nonresident alien, enter amount from Form 1040NR, line 34. Estates and trusts: Enter your taxable income without the deduction for your exemption <i>Caution: If you figured your tax using the maximum tax rate on capital gains, see instructions.</i>	17	35,888	
18	Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1"	18		.1276
19	Individuals: Enter amount from Form 1040, line 40, less any amounts on Form 1040, lines 41, 42, and any mortgage interest credit (from Form 8396) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 39, less any amount on Form 1040NR, line 40 and any mortgage interest credit (from Form 8396) on line 42. Estates and trusts: Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37.	19		6,402
20	Multiply line 19 by line 18 (maximum amount of credit)	20		817
21	Enter the amount from line 13 or line 20, whichever is smaller. (If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate lines in Part IV.)	21		650

Part IV Summary of Credits From Separate Parts III (See instructions.)

22	Credit for taxes on passive income	22		
23	Credit for taxes on high withholding tax interest	23		
24	Credit for taxes on financial services income	24		
25	Credit for taxes on shipping income	25		
26	Credit for taxes on dividends from a DISC or former DISC	26		
27	Credit for taxes on certain distributions from a FSC or former FSC	27		
28	Credit for taxes on lump-sum distributions	28		
29	Credit for taxes on general limitation income (all other income from sources outside the United States)	29		
30	Add lines 22 through 29.	30		
31	Reduction of credit for international boycott operations. See instructions for line 12.	31		
32	Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 38a.	32		



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Worksheet. **Additional Foreign Tax Credit on U.S. Income***

	COL. A	COL. B
<u>I. U.S. tax on U.S. source income</u>		
<u>(U.S. source rules)</u>		
1. Dividends	_____	_____
2. Interest	_____	_____
3. Royalties	_____	_____
4. Capital gain	_____	_____
5. a. Gross earned income	_____	_____
b. Allocable employee business expenses	_____	_____
c. Net compensation	_____	_____
6. a. Gross rent, real property	_____	_____
b. Direct expenses	_____	_____
c. Net rent	_____	_____
7. Other _____	_____	_____
8. Total _____	_____	_____
9. Enter tax amount from line 40, less lines 41 and 42, Form 1040	_____	_____
10. Enter AGI from line 31, Form 1040	_____	_____
11. Divide line 9 by line 10	_____	_____
12. Multiply line 11 by line 8 (estimated U.S. tax on U.S. income)	_____	_____
<u>II. Tax at source allowable under treaty</u>		
A. Items fully taxable by U.S.		
13. a. Identify _____	_____	_____
b. Multiply by line 11	_____	_____
B. Items partly taxable by U.S.		
14. a. Identify _____	_____	_____
b. Treaty rate	_____	_____
c. Allowable tax at source (Multiply line 14a by 14b)	_____	_____
15. a. Identify _____	_____	_____
b. Treaty rate	_____	_____
c. Allowable tax at source (Multiply line 15a by 15b)	_____	_____
16. Total (Add lines 13b, 14c and 15c)	_____	_____
C. Identify each item of U.S. source income from Col. A, Step I, on which U.S. may not, under treaty, tax residents of the other country who are not U.S. citizens _____	_____	_____
_____	_____	_____
_____	_____	_____
<u>III. Additional credit</u>		
17. Residence country tax on U.S. source income before foreign tax credit	_____	_____
18. Foreign tax credit allowed by residence country for U.S. income tax paid	_____	_____
19. Maximum credit. Subtract the greater of line 16 or line 18 from line 12.	_____	_____
20. a. Enter the amount from line 17	_____	_____
b. Enter the greater of line 18 or line 16	_____	_____
c. Subtract line 20b from line 20a	_____	_____
21. Additional credit. Enter amount from line 20c, but no more than line 19. Also add this amount to line 32 of Part IV of Form 1116.	_____	_____

* See the discussion on Tax Treaties for information on when you should use this worksheet.

Worksheet Instructions. **Additional Foreign Tax Credit on U.S. Income**

STEP I

Figure the estimated tax on U.S. income using U.S. source rules.
(See Publication 514 for a brief discussion of these rules.)

Lines 1-7—Add up all items of U.S. source income and enter the gross amounts in Column A , and net amounts, if appropriate, in Column B.

Line 8—Enter the total.

Lines 9-10—Figure your average tax rate by dividing your tax from line 40, less lines 41 and 42, Form 1040, by your adjusted gross income (AGI) from line 31, Form 1040.

Line 11—Express this rate as a decimal.

Line 12—Multiply the rate on line 11 by your U.S. source income to figure your estimated U.S. tax on U.S. source income.

STEP II

Determine the amount of tax that the United States is allowed to collect at source under the treaty on income of residents of the other country who are not U.S. citizens.

PART A—Income fully taxable by the United States. Identify the type of income.

Line 13—Use the average tax rate on the AGI, figured above in Step I.

PART B—Income for which treaty limits U.S. tax at source.

Lines 14-16—Identify each type of income. Use the specified treaty rate.

PART C—Identify the items not taxable at source by the United States under the treaty .

STEP III

Figure the amount of the additional credit for foreign taxes paid or accrued on U.S. source income. The additional credit is limited to the difference between the estimated U.S. tax (STEP I) and the greater of the allowable U.S. tax at source (STEP II) or the foreign tax credit allowed by the residence country (line 18).

Line 17—Enter the amount of the residence country tax on your U.S. source income before reduction for foreign tax credits. If possible, use that fraction of the pre-credit residence country tax which U.S. source taxable income bears to total taxable income. Otherwise, report that fraction of the pre-credit foreign tax which gross U.S. income bears to total gross income for foreign tax purposes.

Line 18—Enter the amount of the foreign tax credit allowed by the residence country for U.S. income tax paid.

Line 19—Figure the maximum credit allowed by subtracting the greater of the tax at source allowable under treaty (line 16) or the foreign tax credit allowed by the residence country (line 18) from the U.S. tax on U.S. source income.

Line 20—Complete line 20 to figure your credit.

Line 21—Enter the amount of additional credit you figured on line 20c, but no more than the maximum credit from line 19. This amount may be claimed as a foreign tax credit on Form 1116. Complete Form 1116 according to the instructions. Add the special credit to line 32, Part IV, of Form 1116 and report that total on your Form 1040. Attach this worksheet to your Form 1116.

